NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents. (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

CIS Congressional Information Service, Washington, D.C.

THE ECONOMY AND THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1989

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

MARCH 16, 1988

Serial 100-60

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

89-987 WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

H781-12.

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J.J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY H. (PETE) STARK, California
ANDY JACOBS, JR., Indiana
HAROLD FORD, Tennessee
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
FRANK J. GUARINI, New Jersey
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
ROBERT T. MATSUI, California
BERYL ANTHONY, JR., Arkansas
RONNIE G. FLIPPO, Alabama
BYRON L. DORGAN, North Dakota
BARBARA B. KENNELLY, Connecticut
BRIAN J. DONNELLY, Massachusetts
WILLIAM J. COYNE, Pennsylvania
MICHAEL A. ANDREWS, Texas
SANDER M. LEVIN, Michigan
JIM MOODY, Wisconsin

JOHN J. DUNCAN, Tennessee
BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
DICK SCHULZE, Pennsylvania
BILL GRADISON, Ohio
WILLIAM M. THOMAS, California
RAYMOND J. McGRATH, New York
HAL DAUB, Nebraska
JUDD GREGG, New Hampshire
HANK BROWN, Colorado
ROD CHANDLER, Washington

ROBERT J. LEONARD, *Chief Counsel*
M. KENNETH BOWLER, *Staff Director*
A.L. SINGLETON, *Minority Chief of Staff*

CONTENTS

Page

Press release of Wednesday, March 2, 1988, announcing the hearing 2

WITNESSES

Office of Management and Budget, Hon. James C. Miller III, Director 4
Congressional Budget Office, James L. Blum, Acting Director 48
U.S. Department of the Treasury, Hon. O. Donaldson Chapoton, Assistant Secretary for Tax Policy 61

Gramlich, Edward M., Institute of Public Policy Studies, University of Michigan 92
McCarthy, F. Ward, Merrill Lynch & Co., Inc 95
Penner, Rudolph G., the Urban Institute 86

SUBMISSIONS FOR THE RECORD

American College of Gastroenterology, statement 111
American Rheumatism Association, statement 114
American Society of Internal Medicine, statement 116
Federation of American Health Systems, Michael D. Bromberg, statement 122
Kelso & Co., Jeffrey R. Gates, statement and attachments 126
National Committee To Preserve Social Security and Medicare, Hon. James Roosevelt, statement 137
Organization for the Preservation of the Public Employees' Retirement Industry and Opposition to Social Security Expansion to Such Industry (OPPOSE), Robert Scott, statement and attachments 139
Renal Physicians Association, statement 150
Senior Review, Inc., Ruth Thompson Jones, statement 153

THE ECONOMY AND THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1989

WEDNESDAY, MARCH 16, 1988

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 9:37 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
WEDNESDAY, MARCH 2, 1988

PRESS RELEASE #23
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3625

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A PUBLIC HEARING ON THE ECONOMY AND THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1989

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced the Committee will hold a one-day public hearing on the economy and the President's Budget for Fiscal Year 1989. The hearing will be held on Wednesday, March 16, 1988, in the Committee's main hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m.

Testimony will be received from Administration officials and invited witnesses only. The leadoff witness at 9:30 a.m. will be the Honorable James C. Miller III, Director of the Office of Management and Budget (OMB), followed by James L. Blum, Acting Director of the Congressional Budget Office. At 2:00 p.m., the Committee will reconvene to hear from representatives of the Department of the Treasury, to be followed by testimony from invited expert witnesses.

It is not anticipated that additional hearings will be scheduled on specific budget proposals. Therefore, interested individuals and organizations are invited to submit written statements for inclusion in the printed record of the hearing.

In announcing this hearing, Chairman Rostenkowski said, "The Administration and Congress worked together last year to develop a deficit reduction package for fiscal year 1989 that meets the goals of the Gramm-Rudman-Hollings law. The Members of this Committee are dedicated to following through on the budget agreement.

"At this hearing the Committee is particularly interested in hearing the Administration's justifications for the revenue proposals contained in the President's budget, and the call for $1.3 billion in medicare reductions, above and beyond those outlined in the budget agreement. The Committee is also interested in the economic outlook. The hearing will inform us of the chances that the OMB deficit estimate on August 25th will be above $146 billion. Further, we hope to gain a longer-term perspective on the economy and future budget deficits, including the prospects for continued economic growth and rising real incomes for all segments of the population. The Committee welcomes suggestions, and will question witnesses, on how to effectively pursue fiscal policy to meet these economic goals."

WRITTEN STATEMENTS FOR THE RECORD:

Any interested person or organization may file a written statement for inclusion in the printed record. Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Friday, April 15, 1988, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman ROSTENKOWSKI. The committee will come to order. Today we will take testimony from the administration officials and invited witnesses on the state of the economy and the President's budget for fiscal year 1989. If the President's budget is any indication, this will be the year in my opinion of the big wink.

There appears to be no stomach at either end of Pennsylvania Avenue for a deficit reduction bill this year. We were all hoping that last year's budget summit agreement would satisfy the Gramm-Rudman target for fiscal year 1989.

Today I would like to find out if we really will meet the Gramm-Rudman target and avoid automatic sequestration next October. On paper, the administration's budget results in a deficit less than $136 billion in fiscal year 1989. We want to know whether it achieves this result from rosy economic forecasts or policy changes that will be very difficult to enact and a healthy dose of asset sales which aren't supposed to count for purposes of Gramm-Rudman.

Among the policy recommendations there are several provisions, many of which lose revenue. These are primarily corporate provisions. These revenue losers will be paid for by requiring all State and local employees and their employers to pay Medicare payroll tax. I think many State and local employees around the country would disagree with the President's claim that there are no tax increases in this budget.

In addition, the President has called for $1.3 billion in Medicare cuts, over and above those enacted as part of last year's budget summit agreement.

I've made no secret of my concern about these Medicare recommendations. I consider them to be a clear violation of the summit agreement, which was signed by the President just 3 months ago.

The Congress and the President made a deal last year. One that was clearly understood by all parties. The President's willingness to renege on the deal is not only disappointing, it sorely tests the spirit of cooperation that resulted in the summit agreement.

I look forward to the testimony and hope that at the end of the day we will have a clearer picture of the state of our economy and the steps we need to take to assure continued economic growth.

Mr. Director, I'm always pleased to see you join us and share with us your thoughts as to just how the economy will be moving and what we can do in this committee to help provide the administration with some direction. I welcome you, Mr. Miller. I will yield first to my colleague, Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I would also like to welcome you to the committee. We are pleased to have you here to present the President's budget proposal and economic forecast for fiscal year 1989 and beyond.

Last year, the Congress, as you well know, and the President negotiated a 2-year agreement, a budget summit that cuts over $70 billion from the Federal deficit. Most of that summit agreement is already enacted. In fact, major portions of it, the tax increases and cuts in domestic spending were the responsibility of the Ways and Means Committee. Further reductions we made last year will be enough to avoid the Gramm-Rudman sequestration process. This year remains to be seen. Nevertheless, contrary to some state-

ments, the President has honored his part of the summit agreement and stayed within the principles outlined by the summit.

The President also has made further recommendations for cuts in Medicare. I realize that you feel these reductions are needed to achieve the savings in the summit because we in the Congress and you in the executive branch count the savings in a different way.

The President has made additional suggestions for changes in revenues which are as always of interest to all the members of this committee.

I hope you will provide us with your insights on these matters, the Gramm-Rudman process itself and the likelihood for sequestration later in the year. We all look forward to your remarks.

Chairman ROSTENKOWSKI. Mr. Brown.

Mr. BROWN. Mr. Chairman, I hope you won't think I'm being critical but we are discouraged that you don't seem to be able to ascertain the difference. The Republican request for higher taxes are revenue enhancement and the Democratic proposals are tax increases. I just wanted to try to make that clear.

Chairman ROSTENKOWSKI. Let the record show that I've been corrected.

Mr. Miller.

STATEMENT OF HON. JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. MILLER. Thank you, Mr. Chairman, Mr. Duncan, other members of the committee. I welcome a chance to be with you this morning and to talk about the administration's proposals of considerable interest to this committee. I know you have a particular concern about the $1.2 billion additional savings in Medicare, over and above what was enacted last year, that is included in this budget.

Let me just say forthrightly and I think as you identified correctly, Mr. Duncan, the proposal contained in this budget is for the purpose in our judgment of carrying out the full extent of the agreement that was consummated last November. I just think the best thing for us to do is to approach it in the following way: not to say that one person, one side or the other has broken the agreement. I don't believe in any way that we have violated the agreement. In fact, the cardinal rule given to us by the President was that we shall not violate the agreement in any of its aspects.

The $1.2 billion in our judgment is necessary to carry out the agreement. In fact, if we did not support the additional savings in Medicare, we would be by acquiescence violating the agreement in my judgment.

Let's say that judgment goes to the question of how you best score these savings and for reasons that I get into in some detail in my formal statement, you can see that our scoring differs with that of CBO's. I would like to run over that just briefly, if I might.

First of all, I think we ought to keep in mind that in this proposal we would not cut Medicare spending. In fact, as you know, we would propose that the rate of growth in Medicare spending be diminished just very slightly.

I've heard it said by many people that in fact the Congress or the administration has tried to balance the budget on the backs of Medicare recipients, those who receive Medicare payments. Nothing could be further from the truth. The facts speak for themselves.

In this administration, since 1981, Medicare spending has more than doubled. For anyone to say that we have somehow tried to balance the budget on the backs of Medicare just flies in the face of that.

Our estimates of the effects of the changes incorporated in last year's reconciliation bill rely upon the Medicare actuaries at the Department of Health and Human Services. This team of experts and statisticians and accountants that have to deal with the incidence of these various diseases and how changes in the law would affect total outlays.

In our judgment and in the Medicare actuary's judgment, the changes that were enacted in the reconciliation bill fell short of the savings agreed to last November. Surely you must understand that the President, presented with this monumental reconciliation bill at the last possible moment, did not have the line item veto to say I agree with this part and I disagree with that part. He was virtually forced to sign the measure, which he did sign, as you recollect, or else see the Government shut down. He had to sign the continuing resolution at the same time.

Let me just emphasize also that it is inherently tricky to try to have CBO and OMB come out with exactly the same numbers, or for any two experts to come out with the same numbers on these things. I'd like to tell you why I think the OMB, the Medicare actuary at HHS, tried to come out to the right numbers. The primary difference is in scoring the PPS fiscal year 1989 update. As you know, significant discretion was afforded the Secretary of HHS regarding the inputs into the decision as to what the PPS update ought to be.

What we have seen over time is that the payment increase that has been granted by Congress has been about one-fourth of the Hospital Market Basket Index. Bear in mind that this index does not include any kind of adjustment for productivity increases and, in most of our economy, we have come to expect productivity increases year after year.

Basically what we have observed is that Congress has enacted increases in the PPS update about one quarter of the Hospital Market Basket Index—that were partly because everyone understands that when the PPS system was set up, it was greatly overpriced. Instead of revising downward or re-basing, as many have advocated, Congress essentially allows a smaller update.

We were on the generous side. In our baseline, we allowed the PPS update for the baseline to be one-half of the Hospital Market Basket Index, not one quarter as Congress has historically been enacting, which I think is the appropriate basis on which to determine the current services baseline, but we allowed fully one-half.

The difference between our assumption for the baseline of one-half the Hospital Market Basket Index, again reflecting productivity gains and so forth, and the full index, which CBO estimates, is a big, big difference. That big difference results in a substantial por-

tion of the $1.2 billion that we believe the enactment of last year's reconciliation failed to deliver with respect to the Medicare savings agreed to last November.

Now one of the problems that we have, of course, is that contrary to what was written in the agreement, OMB and CBO have not—or let's say CBO has not been encouraged and, indeed, in certain instances allowed to discuss with OMB the differences in the scoring and work out the differences in the scoring. And this plainly tricky area, a difficult area to nail down, has led to some great inconsistencies and some scoring of other component parts of the Medicare program, and I review some of those in my written testimony.

Now, as far as the specific savings the administration proposes again to meet, in our judgment, the savings required by the agreement last November, we proposed to reduce the indirect medical add-on for teaching hospitals that was at one point arbitrarily doubled. We propose that it be set at 4.05 percent, which is essentially half of what the number was—the 8.1 percent that has been recently trimmed down to 7.7 percent. But we believe it ought to be at 4.05 percent. And there are several other proposals in the testimony that would indicate the kind of savings that are appropriate, we believe, to meet the agreement of last November.

In the testimony I also discuss the administration's request for the Medicaid program. Medicaid is $32.7 billion for fiscal year 1989, rising to $35.8 billion for fiscal year 1990, and it's increasing at nearly 10 percent a year.

We have not proposed any legislative changes in entitlement policy in Medicaid. However, fine-tuning of the program in the course of the day-to-day administration of a large, complex program like Medicaid goes on. To this end, the budget, as always, contains the effect of regulatory initiatives. The majority of these regulations are not intended for budgetary purposes but simply a matter of making the program work better.

I talk also in the testimony of our approach to catastrophic health insurance. As you know, the President has submitted a bill. However, we believe that the bill passed by the House is unacceptable. We believe that the bill passed by the Senate is much more on the mark.

I discuss several other matters in my testimony, but if you wish to go into them, we shall. I don't want to take too much of your time.

Let me finally end with an observation. Mr. Duncan and Chairman Rostenkowski, you raised the question about whether we would hit the Gramm-Rudman-Hollings targets, whether we would stay within the agreement.

As you both will remember, during the budget negotiations, I indicated that there was some chance that carrying out the four corners of the agreement would not get us within the Gramm-Rudman-Hollings strictures. It depended on how the economy performed, what assumptions we made, and so forth.

I am happy to report that carrying out the four corners of the agreement, in our judgment, gets us within the Gramm-Rudman-Hollings strictures. It does not trigger a sequester. It barely avoided a sequester; there is not a lot of room to spare. We estimate that

the deficit under the President's budget would be $129.5 billion. That's $6.5 billion less than the $136 billion target under Gramm-Rudman-Hollings.

If you make the adjustments called for in the Gramm-Rudman-Hollings language to determine whether a sequester is needed—that is, if you excise from that deficit certain asset sales and make other complicated adjustments, the baseline number we come up with is $142.7 billion, which is below the $146 billion margin of error which would trigger sequester.

If the President's budget is enacted, and virtually the same thing, if the budget agreement is carried out in all of its major four corners; we will avoid a sequester this year. This assumes that the economy does not deteriorate, or, put another way, that the economy performs as forecast in the budget.

Now I know some others disagree. CBO is much more pessimistic than we are. There are some people, if you look at the blue chip estimators, that are more pessimistic than we are; some that are more optimistic than we are. As a matter of fact since we settled on these figures last December, the blue chip forecasters have been moving our way, because the data that they see coming in give rise to their thinking that the economy will be more robust this year than they thought previously.

I do believe, however, that it's going to be close. If the economy does not perform as we expect, then next August when we make our forecast, when we under the Gramm-Rudman-Hollings rule issue our report, there might be the need for a sequester. That's speculative at this time. I don't think there's anything that we should do in preparation for that unless we see severe troubles in the economy. As long as the economy continues to perform well, we see no reason that there should be a sequester next August. Should it appear that there would be a sequester, I think the President would welcome again an opportunity to sit down with the leaders of Congress and to work out some alternative to a sequester.

I just want to emphasize that that's premature at this moment in our judgment, that it is speculative, that we do not anticipate that event. We believe that the enactment of the budget agreement, enactment of the President's budget, would avoid a sequester.

Thank you, Mr. Chairman. I would ask that my testimony be inserted in the record.

Chairman ROSTENKOWSKI. Well, without objection, your entire statement, Mr. Miller, will be included in the record.

[The prepared statement of Mr. Miller follows:]

STATEMENT
of
JAMES C. MILLER III
DIRECTOR
OFFICE OF MANAGEMENT AND BUDGET
before the
COMMITTEE ON WAYS AND MEANS
of the
UNITED STATES HOUSE OF REPRESENTATIVES
March 16, 1988

Mr. Chairman and Members of the Committee: I am pleased to be here to discuss Medicare and the other entitlement programs under your jurisdiction. I know you have a particular interest in the $1.2 billion reduction in Medicare included in the President's FY 1989 budget, and so I'll deal with that first.

Need for Additional Medicare Savings

The Bipartisan Budget Agreement negotiated last November called for Medicare savings of $2.0 billion in FY 1988 and $3.5 billion in FY 1989. These savings were not in fact "cuts", since even with them the level of Medicare spending continues to rise. Instead, with the savings imposed by the Agreement there is a slight reduction in the rate of growth in Medicare expenditures.

Our estimates of the effects of the changes incorporated in last year's reconciliation bill relied on the experience and expertise of the Medicare Actuary at the Department of Health and Human Services (HHS). By his scoring, reconciliation reduced spending over two years by $1.2 billion less than called for in the Bipartisan Budget Agreement. So, to meet the terms of the Agreement, the President's budget proposes $1.2 billion in additional Medicare savings.

A little background probably would be helpful. During the first day of the Bipartisan Budget Negotiations last November it was agreed that we would use, as a spending and revenue baseline, the Office of Management and Budget's (OMB's) Gramm-Rudman-Hollings (G-R-H) report published on October 20, 1987. Recognizing that estimating entitlement savings -- particularly in Medicare -- is always tricky, the Bipartisan Budget Negotiators, in their release describing the Agreement, indicated that "CBO and OMB shall work together to resolve scoring methodology problems on mandatory accounts."

During the initial negotiations with the Senate Finance Committee, Congressional and Administration experts worked out differences in scoring. However, in the Conference negotiations the Administration's experts were shut out of the process. Despite the admonition in the Bipartisan Budget Agreement release, there was no opportunity for discussions over scoring methodology. Instead, in the end, the Conference adopted Congressional Budget Office (CBO) scoring -- which, as I have indicated, purported to provide estimated savings of $1.2 billion more than that established by the Medicare Actuary.

This outcome we found particularly disturbing. First, it violated the admonition in the Bipartisan Budget Agreement release to which I have just alluded. Second, under G-R-H procedure, it is the OMB scoring that counts, not CBO's, in determining whether we ultimately meet our deficit reduction targets. (Otherwise, the G-R-H procedure is unconstitutional.) Third, the Chairman of the Bipartisan Budget Negotiators, House Majority Leader Tom Foley, had repeatedly said publicly that the Agreement's savings, in the end, would be scored by OMB. And fourth, when OMB's estimates of savings were higher than CBO's in other areas, such as agriculture, Congress chose to use the higher scoring.

The largest difference in OMB vs. CBO scoring can be traced to the choice of a baseline for measuring the savings in hospital payments under the Prospective Payment System (PPS). In the past three years, once all the factors affecting hospital costs were addressed, the PPS increase has averaged one-fourth of the hospital inflation index. This is due in part to the widespread recognition that when the PPS system was first established in 1983, it was greatly inflated; thus, calls for "rebasing" have been dealt with by allowing substantially less than the full inflation index. However, in scoring the Medicare savings, the Conference assumed full inflation in its baseline and against that inflated baseline estimated $245 million in savings in FY 1988 and $1.4 billion savings in FY 1989. On the other hand, we reviewed all the factors that under law must be considered when setting the PPS update, and established a baseline reflecting an update factor of one-half the hospital inflation index. Let me say once again: recent experience has shown the actual update factor to be only one-fourth the inflation index, so our update at one-half was quite generous. On this basis, the Medicare Actuary estimated the Medicare savings to be $180 million for FY 1988 and only $250 million for FY 1989.

Although the PPS baseline accounts for most of the variation in OMB and CBO estimates for Medicare, other factors affecting other items, such as different assumptions about demand for services and the rate of implementation of spending reductions by the agency, can also affect the accuracy of the estimates. The Bipartisan Budget Agreement's requirement that OMB and CBO work together to resolve methodological differences recognized that consistency was important.

Unfortunately, the Conference's decision to exclude the Administration's experts and to rely on CBO's savings estimates resulted in overall spending estimates with known inconsistencies. For example,

- The Medicare Actuary estimates that the provision that extends the Part B premium at 25 percent of Part B costs will save $645 million in FY 1989, while CBO estimates savings will be only $260 million.

- For most provisions that are intended to limit spending on physicians, CBO scores greater FY 1988 savings than does the Medicare Actuary. For example, CBO estimates that the provision that limits the inflation increase for physician services saves $735 million in the two years FY 1988 and FY 1989, while the Medicare Actuary estimates total two-year savings of $530 million. In contrast, the Medicare Actuary estimates much smaller FY 1989 costs ($5 million versus CBO's $30 million) for a provision that pays physicians in rural underserved areas a bonus, because the actuary assumes far fewer physicians.

- The Medicare Actuary assumes that a series of changes to the way Medicare pays for durable medical equipment will increase costs over time, while CBO estimates net savings will result. The total difference is $100 million in FY 1988 and FY 1989 combined.

- The Medicare Actuary estimates lower costs for an expanded mental health benefit than CBO did ($90 million over two years versus CBO's estimate of $140 million over two years).

Let me make the point here that even with the additional $1.2 billion savings in Medicare proposed by the Administration to meet the terms of the Bipartisan Budget Agreement, spending for this program continues to increase at a rate far exceeding that of defense, social security, and interest on the federal debt. Despite well-publicized "cuts" in Medicare spending, actual outlays increased from $39.1 billion in FY 1981 to an estimated $78.9 billion in FY 1988 -- more than double. And despite a series of reforms and incremental changes, spending on physician services also has more than doubled -- from $9.5 billion in FY 1981 to an estimated $24.7 billion in FY 1988.

Given the situation, I urge this Committee to approve the Administration's proposal, the matter to which I now turn.

Administration's Medicare Savings Proposal

The President's budget proposes to reduce the increase in FY 1989 Medicare spending by $1.2 billion, in order to implement fully the two-year savings target agreed to in the *Bipartisan Budget Agreement*. In Part A (Hospital Insurance) savings would be achieved by:

- Reducing the indirect medical education add-on to PPS from 7.70 percent to 4.05 percent. Teaching hospitals receive an add-on payment to account for the historically higher costs associated with teaching care. this adjustment was doubled arbitrarily when the pps system was instituted. In 1986, teaching hospitals received PPS payments that were an estimated 13 percent in excess of operating costs -- making teaching hospitals the most advantaged class of hospitals under PPS. The President's budget proposes to reduce the teaching add-on to a more analytically appropriate level, and to make the ratio of payments to costs for teaching hospitals more consistent with other classes of hospitals.

- Limiting the per-resident payment for graduate medical education to a resident's actual stipend, fringes, and overhead directly related to classroom activities. These payments were intended to be transitional when initiated, but effectively have become a permanent subsidy to those receiving them.

A series of incremental reforms in Part B of Medicare would also help limit the future increase in the Part B premium which is paid by the nation's aged and disabled. These reforms include:

- Setting the CY 1989 prevailing charges for 12 specified groups of currently-overpriced physician procedures at CY 1988 levels, reduced by 5 percent, subject to a national floor.

- Delaying the use of a fee schedule for radiologic services until January 1, 1990; instead, reducing payments to radiologists by 10 percent in CY 1989.

- Delaying the use of a relative value guide for anesthesiology services until January 1, 1990; instead, reducing payments to anesthesiologists by 10 percent in CY 1989, and basing future payment amounts on the CY 1989 level.

- Eliminating duplicative payments for physicians performing surgery while supervising certified registered nurse anesthesiologists providing anesthesia services.

- Establishing a fee schedule for enteral products, supplies, and equipment based on the lesser of existing lowest charge level limits and national limits derived from wholesale and retail price information; Medicare would pay the lesser of actual charges and the fee schedule amounts.

- For durable medical equipment and prosthetic devices subject to the OBRA 1987 rental cap which is the lesser of actual charges and fee schedule amounts: (a) allowing the purchase and lease-purchase of such items, as permitted prior to OBRA 1987; (b) basing fee schedules for these items on average reasonable charges or discounted submitted charges rather than submitted charges; and (c) limiting rental payments to 15 months in the case of lease-purchase and 13 months in all other cases.

- Limiting payments for oxygen equipment and supplies to 90 percent of an inflation-adjusted base rate, based on the CY 1986 average monthly reasonable charges calculated by each carrier.

- Standardizing Medicare payments for End-Stage Renal Disease (ESRD) under Method II, which permits beneficiaries to acquire home dialysis equipment and supplies from suppliers. Medicare payments for Method II, now based upon reasonable charges, would be limited to the national average ESRD composite rate. To ensure fair treatment, requiring that beneficiaries obtain an agreement with one supplier to furnish all dialysis supplies and equipment.

- Making the penalty provision for employer non-compliance with working aged and End Stage Renal Disease (ESRD) secondary payer provisions conform to that of the working disabled; that is, requiring employers violating those secondary payer provisions to pay an excise tax equal to 25 percent of the group's health plan's expenses.

Even with the changes the Administration proposes, Medicare spending will increase by 6.5 percent from FY 1988 to FY 1989 -- slightly more growth than could be explained by beneficiary increases and inflation. Over the long run, Medicare growth is still projected to be remarkably high. Medicare spending will increase by an estimated 62 percent by FY 1993 -- from the current (FY 1988) spending level of $79 billion to $128 billion. Between 1980 and 1993 -- 13 years -- the program will quadruple under current projections. Medicare outlays would thus exceed spending for either social security or defebse by 2010 -- and exceed spending for Social Security and Defense combined by 2022.

Adminstration's Other Proposals

Medicaid

The Adminstration's request for the Medicaid program is $32.7 billion for FY 1989 and $35.8 billion for FY 1990. Spending under current law for the Medicaid program is projected to increase by 9.5 percent in FY 1989.

Consistent with the Bipartisan Budget Agreement, the Administration will not propose legislation for the Medicaid program this year. As always, the Budget contains a set of regulatory and administrative initiatives. Such initiatives are part of the ongoing process of fine tuning the program, responding to change, and incorporating new ideas to improve the system. The budget effect of these initiatives is a net reduction of $413 million in FY 1989. Not all of these initiatives are intended as cost containment measures, but are, instead, efforts to clarify current policies. Those that are intended for cost containment are measures which will provide guidance and encouragement to the States to adopt practices which will provide for greater equity in the system and to promote more cost effective and higher quality medical care.

Catastrophic Health Insurance (CHI)

Catastrophic health insurance legislation proposed by the President is now awaiting final conference action. Throughout the catastrophic health insurance debate, the Administration has remained firmly committed to the goal of providing affordable, acute-care catastrophic illness protection.

The President's original proposal called for a responsible, deficit-neutral program that limited the expenses a beneficiary would have to pay out-of-pocket for Medicare-covered services in any given year. Beneficiaries would have paid for this increase in protection with a modest increase in premium.

The House of Representatives, in passing an alternative catastrophic health insurance bill (H.R. 2470) in July of 1987, converted the President's sound, reasonable proposal into a massive program that imposed a prohibitive tax increase on the elderly and threatened bankruptcy for the Medicare trust funds. The House went well beyond providing catastrophic protection, adding a prohibitively expensive outpatient drug benefit and numerous other Medicare and Medicaid expansions unrelated to acute-care catastrophic protection. The House approved this excessively expensive bill, rejecting a responsible alternative introduced by Representative Michel.

Working together, the Administration and Members of the Senate Finance Committee produced a sound catastrophic health insurance bill -- one consistent with the mutually accepted principles of sound financing, affordability, and deficit neutrality. The Senate-passed bill guaranteed that a constant percentage of beneficiaries would receive catastrophic protection each year and assured an outpatient prescription drug benefit that remained soundly financed by an affordable premium.

As you begin a difficult and potentially contentious conference on this measure, I want to assure you that the Administration remains committed to the enactment of legislation providing affordable, acute-care catastrophic illness protection and outpatient prescription drug coverage for our nation's elderly and disabled. However, such legislation must be deficit neutral, with benefits paid from newly created trust funds that are soundly and fully financed from beneficiary premiums.

Maternal and Child Health Block Grant

The Administration's FY 1989 budget request includes $561 million for the Maternal and Child Health Block Grant -- an increase of $34 million or 6.5 percent over the FY 1988 level. This request is at the full authorization level. It will provide States with a stable source of financial support, targetting a broad range of services for maintaining and improving the health of mothers and children.

Hospital Insurance -- State and Local Coverage

As you know, State and local government employees hired after March 31, 1986 pay for and receive Hospital Insurance coverage under Medicare. The President's budget extends this valuable coverage to all State and local government employees regardless of when first hired.

This is an important provision. Among those employees hired before April 1, 1986, nearly 25 percent are not assured of hospital, physician, and related Medicare protection because their jobs are not covered by Medicare.

At the same time, this provision eliminates tremendous Medicare windfalls that nearly 75 percent of uncovered State and local employees will receive due to loopholes in the system. We must require these individuals to pay their fair share for coverage. Also, this will help lessen the drain on the financially troubled Hospital Insurance Trust Fund.

For your information, this provision generates revenues in excess of costs for the Hospital Insurance Trust Fund in the short run. In the long run, however, Medicare costs will exceed revenues, because Hospital Insurance coverage includes later eligibility for Supplemental Medical Insurance, which currently receives a 75 percent general fund subsidy.

AFDC and Child Support Enforcement

Mr. Chairman, for AFDC and Child Support Enforcement, the budget reflects H.R. 3200, the AFDC Employment and Training Reorganization Act of 1987. This proposed Act builds upon new research and lessons learned from the States and would put in place a process for learning more about how to prevent and reduce welfare dependency. The President has endorsed this forward-looking and responsible legislation.

Under H.R. 3200, States would be expected to involve meaningful and growing numbers of AFDC recipients -- particularly those likely to become long-term dependents -- in activities to increase their self-sufficiency. In exchange, States would receive almost triple the Federal resources dedicated to employment and training programs for AFDC recipients. And these funds would still stay within the domestic discretionary spending cap agreed to in the Bipartisan Budget Agreement.

H.R. 3200 also would strengthen our Federal-State Child Support Enforcement program. Mandatory use of State-established guidelines in setting award amounts, automatic wage withholding of court-ordered support payments, and improved procedures for paternity establishment and inter-State enforcement of child support -- all of these provisions under H.R. 3200 would help ensure children receive adequate and timely support from their absent parents.

In addition to specific changes in AFDC employment and Child Support Enforcement, H.R. 3200 includes the broad demonstration authority sought by the President to allow for careful testing of innovative alternatives to current arrangements in the large array of programs that constitute our public assistance "system". The lessons learned from the demonstrations undertaken under H.R. 3200 would inform policy-makers for years to come.

We urge your support of this bill.

Social Services Block Grant

The President's FY 1989 budget requests provides funding for the Social Services Block Grant (SSBG) at the full authorization level of $2.7 billion. Child day care, child and adult protective services, home management and maintenance services, employment and legal services, and transportation will continue to be supported by the States through SSBG grants.

Foster Care and Adoption Assistance

For FY 1989 the President requests $1.1 billion for Foster Care and Adoption Assistance. These resources will fund programs to keep families together, support children who cannot continue to live with their families, provide adoptive homes when reunification of children and families is not possible, and support research and demonstrations designed to strengthen families and reduce barriers to the adoption of children with special needs.

Consistent with the Bipartisan Budget Agreement, the Administration's request represents HHS' most recent current services estimates, and includes $109 million to pay approved State claims for foster care expenditures before 1987, commonly known as prior years' claims. We remain concerned that State administrative costs associated with these programs have increased 500 percent over the last four years. Worse yet, administrative costs in 16 States have increased over 1,000 percent.

The President's budget requests $832 million for the Foster Care program to provide maintenance payments for children who must live outside their homes. This is an increase of $174 million over the FY 1988 level. The FY 1989 request reflects increased State claims, as noted particularly for administrative costs, and a slight increase in the average monthly number of children in foster care to 115,000.

The request of $134 million for Adoption Assistance represents an increase of $26 million over the FY 1988 appropriated level. This request reflects increased State expenditures and continued growth in the number of children assisted to nearly 44,000.

Social Security Administration

Consistent with the Bipartisan Budget Agreement, the Administration proposes no legislative changes in social security financing or benefits. Also, there are no proposed changes for the Supplemental Security Income program or for the Special Benefits for Disabled Coal Miners.

Railroad Retirement Board

Let me turn now to a specific proposal included in the President's budget -- privatizing the rail industry's pension system.

As you may know, the rail pension fund has a long history of financial crises. Congress was forced to enact major rail pension financing legislation in 1974, 1981, and 1983 to prevent insolvency. These refinancing laws were supposed to put rail pensions on a sound financial track, but in each instance revenue projections proved to be too optimistic. Railroad Retirement Board (RRB) actuaries are again projecting that the rail pension fund will go broke.

The Administration believes the long-term solution for rail pension solvency lies in the private sector. Restoring rail pensions -- that is, the amounts above Social Security equivalent levels -- to the private sector would free rail labor and management to bargain collectively their pension system without inappropriate Federal intrusion. Also, privatization would ensure sound financing of rail workers' pensions by extending Employee Retirement Income Security Act (ERISA) financing rules to new rail workers and giving full Social Security coverage to all rail workers. We plan to transmit privatization legislation to Congress late this year.

We also believe it is advisable to reverse section 9034 of the 1987 Omnibus Budget Reconciliation Act, which gives $390 million to the rail sector's pension fund. Such subsidies dilute the incentive for rail labor and management to negotiate in good faith for a solution that does not include large taxpayer support. Removing the subsidy would send the message that the rail sector must be held to its longstanding commitment to pay for its own pensions.

. . . . . .

Mr. Chairman and Members of the Committee: that completes my prepared statement. Now, I shall be happy to address any questions you might have.

Chairman ROSTENKOWSKI. I hope that you are correct. I am not looking forward to going through either another summer or another sequestration.

My understanding of the summit, Mr. Miller, is that we agreed to $500 million more Medicare savings in fiscal years 1988 and 1989 than the House-passed bill. Using CBO numbers, that meant savings of about $2 billion in fiscal year 1988, and $3.5 billion in fiscal year 1989.

Using OMB numbers would have meant a different set of savings as far as numbers are concerned. Mr. Miller, by your accounting, did we achieve the Medicare savings of $500 million greater than the House-passed bill?

Mr. MILLER. Well, I don't have that figure, but my recollection, Mr. Chairman, is different from yours. My recollection is that we agreed to specific savings numbers, and they were written on the 3-page handout that was circulated when the leadership visited with the President. There were these savings listed on that handout, and they were not deltas over the House-passed version or versus the CBO——

Chairman ROSTENKOWSKI. When we were in the conference, Mr. Director, there was a question as to whether or not we were going to increase the savings by $500 million from the House-passed bill, and I remember Senator Bentsen and I agreed that it would be from the base of the House-passed bill, and I believe that we achieved that.

Now I'm sure that you were there——

Mr. MILLER. I was there, Mr. Chairman, I was there probably more than anyone else.

Chairman ROSTENKOWSKI. No question about that.

Mr. MILLER. I was there virtually every moment. But my recollection is that how much more savings there would be was discussed, but the agreement was in terms of the absolute savings, not the deltas over the House-passed bill, and——

Chairman ROSTENKOWSKI. I left with the impression that we were going to increase the savings by $500 million from what was passed by the House of Representatives. I'm sorry that we didn't interpret at least what Senator Bentsen and I——

Mr. MILLER. But could I make the point, however, that we did work with Senator Bentsen's Finance Committee, and the version of Medicare that was incorporated in the Senate reconciliation bill comported with our estimates of the savings necessary. It was in conference that the changes were made.

Chairman ROSTENKOWSKI. Well, I just remember that when we discussed and when I agreed to the increase of $500 million, it was from the CBO estimates and it was from the House-passed bill.

Mr. Duncan, you may inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Mr. Miller, I think you indicated that in the past you have been a little more optimistic and the CBO has been a little more pessimistic, but I think you have been correct more often than the CBO?

Mr. MILLER. Mr. Duncan, I was telling Representative Brown just a few minutes ago that if I had a crystal ball and I could tell all the numbers, I wouldn't be doing the job I'm doing. I'd be rich. I'd

be on the outside making a lot of money. So inevitably, making these forecasts is fraught with some uncertainty. You just do the best job you can. That's what we did last year and that's what we're doing this year. Last year I came before this very committee, and many members of the committee chastised me for coming up with what they called a rosy scenario. That is to say that we were far too optimistic.

Well, as it turns out, the economy performed last year much better. Economic growth was greater than we assumed. The inflation rate was lower than we assumed. And so it turned out we were pessimistic.

This year we used the same methodology, and we came up again with our estimates. And it may turn out that the economy doesn't perform as well as we thought. It may turn out that it performs better than we thought. But it's the best we can do.

Mr. DUNCAN. What improvement in the trade deficit do you assume in your forecast, and how does it affect the growth?

Mr. MILLER. I don't think the forecast incorporates specific numbers on the trade deficit, but we see an improvement in the trade deficit, that is to say a narrowing of the trade deficit, for reasons having to do both with economic theory and with experience. That is, we have looked at the data. The data show a turnaround, or the beginning of a turnaround, in the trade deficit.

Moreover, we are depending on a good deal of export-led growth in this budget. There probably will be more than we have accounted for in calendar year 1988, and certainly in 1989. So we see an improvement.

Mr. DUNCAN. Mr. Miller, on the sale of assets, we have a lot of debate going on down our way. I'm sure you are aware of the fact that the TVA is owned by the power-users, that they have paid the Federal Government back, and that they are paying back every dime that was put in the power program—not the development, but the power program. Do you have any plans to include the TVA in the sale of assets?

Mr. MILLER. Well, we do not have any plan of the sale of assets, per se, for TVA, but we do incorporate in this budget, as we have in several years previously——

Mr. DUNCAN. Energy development, I'm aware of that.

Mr. MILLER. The so-called community development.

Mr. DUNCAN. But you don't have any now or in the future?

Mr. MILLER. No, no sale of assets.

Mr. DUNCAN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

Thank you, Mr. Director, for coming. I would like to pick up on a comment that Mr. Duncan made just a minute ago. Mr. Director, I have asked the Congressional Research Service to compare the accuracy of your OMB budget deficit projections since you have been in office with those of the CBO. As you point out, this is an inexact science. We can't be sure. But according to these figures from CRS, OMB has underestimated the deficit for 6 out of the last 6 years, and for 5 out of the last 6 years, CBO has been more accurate than has OMB.

I'm sorry, I would like to correct myself. OMB has underestimated the budget 5 out of the last 6 years, and CBO has been more accurate at this stage than OMB for 5 out of the last 6 years.

Understandably, no one is eager to declare now that we have to start cutting the budget and go into another reconciliation bill in order to meet the Gramm-Rudman targets. But aren't you a little concerned about this record of accuracy, or maybe a better word is inaccuracy, on the part of your estimate?

Mr. MILLER. No, Congressman. Let me, if I could, explain. I haven't seen the CRS study. I'd be more than happy to review it and give you comments on it, if you would like. But let's keep in mind that usually what is made of the estimates are the estimates of the deficit that are contained in the budget.

The fact of the matter is that Congress has not passed the President's budget. It should come as no surprise that the actual deficit turns out to be higher than the deficit that is incorporated in the President's budget because Congress has failed to incorporate the savings that the President has asked for. That's No. 1.

No. 2, there was a General Accounting Office study a couple of years ago which compared OMB and CBO and private forecasters. GAO looked at their forecasts of the economy—not forecasts of the deficit, which is of course a reflection of what Congress and the President do with respect to appropriating funds and entitlement reforms and that sort of thing. Based on the estimates that GAO came up with, they reached a conclusion that neither CBO nor OMB seemed to have the upper hand in terms of forecasting, nor did they seem to be particularly better or worse than private forecasters.

I would just repeat what I said earlier. Last year we came up with an estimate that was characterized as a rosy scenario, but in fact, when all the data were in, the economy grew faster than we had estimated, inflation rates were lower than we estimated, and the fiscal year 1987 deficit was considerably lower than we had estimated.

Mr. PEASE. According to the CRS, you estimated at this point last year a deficit of $143.6 billion. It turned out to be $148 billion for fiscal 1987. So even last year, according to CRS, you underestimated the deficit.

Mr. MILLER. Well, no, again I would have to look at the study. This time last year we came in and said that the deficit for fiscal year 1987 would be $173 billion incorporating $2 billion worth of rescissions, or $175 billion if the rescissions were not enacted. The rescissions were not enacted, so that the baseline really for comparison is $175 billion. The deficit turned out to be approximately $150 billion. So we were $25 billion too high.

I can't remember the exact number we had in the midsession review for the deficit for 1987, but I think it was close to $150 billion.

Mr. PEASE. Mr. Director, I'll be happy to exchange studies with you. You give me your GAO study and I'll give you my CRS study.

Mr. MILLER. Fine.

Mr. PEASE. Good, but this CRS study, leaving aside whether Congress adopted all the President's recommendations or not, clearly

shows that in 5 of the last 6 years, CBO was more accurate than OMB at this stage in estimating deficits.

I am concerned about that because I think we are all kidding ourselves if we put on our rosy glasses now and assume that you are right and then wind up in August or September, 60 days before the election and 30 days before the end of the congressional session, and find out that we have to go through a big deficit reduction in order to avoid sequestration.

The question is, how badly does the administration want to avoid sequestration? Are you prepared to maintain your rosy scenario next August too?

Mr. MILLER. Well, Mr. Pease, I just disagree with the underlying predicate of your question. This is not a rosy scenario. It is a very realistic scenario. It is using the methodology we used last year, where we were too pessimistic—not optimistic enough.

We want to avoid a sequester. I don't think a sequester is in anyone's interest, and as I have indicated, I think that if the economy continues to perform we will avoid a sequester.

Let me say that while I realize that CBO's numbers are at variance with our own, under the Gramm-Rudman-Hollings law, it is the OMB or the administration's calculations of the deficit that prevail, not CBO's.

Mr. PEASE. That is exactly why I was wondering how badly you want to avoid sequestration, because you will be the ones who will actually make the determination.

Let me turn now to the revenue side. For the last couple of years, the administration has taken a very broad view of what constitutes a tax increase. Anything that increases revenue in your opinion has been a tax increase, or revenue enhancer, depending who you are talking with.

In my State of Ohio, if your recommendations are adopted this time, a lot of people who are not now paying the 1.45 percent Medicare tax will be paying it and a lot of hard-pressed school districts and city halls and township halls will be paying a 1.45 percent also as the employer share.

Isn't that really a tax increase?

Mr. MILLER. Well, Mr. Pease, let me say a few things.

No. 1, I don't know the specifics of the demographics in Ohio, but on average nationwide, about 25 percent of such employees do not have the coverage that Medicare affords, and this proposal that we have, while it would raise revenue, would afford them protection.

Second, it is an equity matter as well. That is to say that some 75 percent of the people not covered by Medicare become eligible for Medicare benefits without having paid for them and we believe this is inequitable to those who have to pay higher premiums because others get a free ride.

The third point that I would make is that in terms of total revenue, this budget proposal is completely neutral. While there are a couple of small items that would raise revenue, there are a couple of other items—dealing particularly with our trying to enhance research and development, technological change, and progress in our country—that would be slight revenue losers. Overall, the changes that we proposed are revenue neutral.

The $14 billion of increased revenue for fiscal year 1989 that was called for in the budget agreement was incorporated in the Reconciliation Act that was passed last December and signed by the President.

So, there are no new taxes, on balance.

Mr. PEASE. No new taxes "on balance." I am glad you put that "on balance" in there.

Mr. Director, I am delighted to hear what you say. What I understand you to say is that in terms of revenue provisions, as long as the revenue provisions seek to provide equity in the Tax Code—you defined that a minute ago, equity—and as long as they are revenue neutral, you don't particularly mind if we add in provisions of our own which we think will contribute to equity in the Tax Code, as long we provide other provisions which will pay for them. Is that your position?

Mr. MILLER. Well, I don't think I would agree with that wide open statement. I mean we would certainly look at whatever you propose. Our objective this year is not to really reopen the Tax Code. We think that would be a big mistake. But consistent with some discussions we have had with various individuals, members of the committee and others, we make these very minor proposals in the President's budget.

Mr. PEASE. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Dorgan will inquire.

Mr. DORGAN. Thank you, Mr. Chairman.

Director Miller, welcome. I would like to ask you some questions about Social Security and the budget and how Gramm-Rudman fused the consideration of Social Security fund balances with the budget deficit.

In the Social Security reform package that passed this committee I had included language that takes the Social Security system out of the uniform budget. Unfortunately, my amendment was amended so that it would not take effect until the early 1990s. Then Gramm-Rudman came along and took it out of the unified budget but fused it for the purpose of determining what the deficit was.

Now it seems to me that the deficit that is reported to the American people understates the deficit by an amount equal to the surplus in the Social Security fund.

Would that be a correct statement?

Mr. MILLER. Well, in terms of an operating budget, that is correct. I mean it depends on how you define receipts and expenses.

For the purpose of the consolidated budget of the United States, you ask yourself what money leaves the private sector and goes into Government, and what money goes from the public sector into the private sector. On that basis, the total that includes the Social Security surplus, which is quite substantial this year, is an appropriate measure of the deficit.

Mr. DORGAN. What is the expected deficit this fiscal year?

Mr. MILLER. It is $30-something billion.

Mr. DORGAN. What is the expected Federal deficit?

Mr. MILLER. $129.5.

Mr. DORGAN. That $129.5, if reached, would really represent a deficit that is about $38 billion more than that if you understood that the Social Security taxes we collect from working people in

this country are dedicated taxes that can only be used for Social Security. But if you use them to offset operating budget losses, you are using money that can never be appropriately committed to pay for those expenses on the operating side.

Isn't that a dishonest representation and a dangerous one? What are we going to do in the early 1990s when we have a $90 billion cliff on Social Security? Are you going to take Social Security money from working folks and use it to offset the purchase of tanks or SDI research?

Is that an honest way to budget in your opinion?

Mr. MILLER. Well, for the purposes of the way we usually talk about the deficit—as being a burden on future generations, and perhaps crowding out current savings and current investment—I think the way we do it is appropriate.

On the other hand, there is nothing dishonest about it. After all, we report in this document all of the information. It is there for anybody to read. We are not hiding anything at all.

Mr. DORGAN. I understand that, but the deficit that is reported generally by you and around this country, the deficit that is understood by the American people, is the $138 billion or the number that represents using sizable Social Security surpluses to offset operating budget deficits or losses.

When do we deal with this issue? When the largest baby crop in our history hits the retirement rolls and we need a substantial amount of money to pay them, what kind of reserve will we have to deal with these Social Security problems in the 2015 or 2020? We are taking $90 billion out of workers' pockets as an offset against defense expenditures or domestic expenditures in the operating budget. When will we fix this serious problem?

Mr. MILLER. Well, let me say I would feel better about it—everything else equal—if the Social Security trust funds, in terms of what we are talking about here, were neither running a surplus nor a deficit. Then there would be no difference.

Mr. DORGAN. We need to have it run a surplus at the moment to meet some very serious strains in the year 2010 or 2015. This is by design. The problem is that what we have designed is being seized by this budget process to make the deficit look smaller and to offset Social Security taxes against other expenditures on the domestic and military side. I think that is dishonest, frankly.

Mr. MILLER. I don't think it is dishonest. I think you have a point of view, and it is a point of view that many share. I think it is also something that we need to be concerned about because, as you point out, the Social Security trust funds are really holding obligations of the Federal Government as assets. But, on the other hand, I don't think it is dishonest. The taxes that are presently paid into Social Security either by the employees or by the employers do have an incentive effect and do burden them.

Mr. DORGAN. But they are dedicated and can be used only for one purpose. If they are used to offset expenditures on the other side, it's wrong.

As we march toward this cliff, you will be gone, so how does somebody else who gets to that cliff deal with it when they take the next step. Is there a solution to it? Will you help us work towards it?

Mr. MILLER. I will help you work toward it. One way you would work toward it, I think, is by taking every opportunity, consistent with the agreements that we have to realize additional savings. I hope then we can count on you to support the additional $1.2 billion in Medicare savings that are incorporated in the budget.

Mr. DORGAN. Well, you have always been able to count on me. The question here is, what do we do about this $90 billion cliff that we are marching towards on Social Security? It is going to happen in 3–4 years and you will be gone but that cliff will be there.

What you could get to is a point where you say, we have got a balanced budget. Regretfully, you get there by using $100 billion in Social Security collections from workers' paychecks. That money can only be used for Social Security and you have offset it against operating losses.

Mr. MILLER. Well, I don't say you—please don't say you——

Mr. DORGAN. Collectively.

Mr. MILLER. Collectively—oh.

Mr. DORGAN. So how do we fix it?

Mr. MILLER. I was not part of the negotiations that set up the Social Security trust fund the way it is.

Mr. DORGAN. What treated Social Security the way it is now in total deficits. I assume you were a part of the Gramm-Rudman negotiations that altered this?

Mr. MILLER. No, Social Security has been on budget since President Johnson put it on budget. He put it on budget precisely to indicate that the deficit was lower than arguably it was before he put it on budget.

Mr. DORGAN. That's correct. That was in the late 1960s, but what happened was in Gramm-Rudman they took Social Security out of the unified budget but fused it for comparison purposes. I am saying that this problem was exacerbated by what happened in Gramm-Rudman, and when Gramm-Rudman plays itself out, you have got a $90 billion cliff out there.

How do we deal with that?

Mr. MILLER. Let me say that I think it is going to require some very careful discussion by a number of people. No. 1, Social Security is an extraordinarily sensitive political issue. Second, I think you must face the fact that as everyone knows there are going to be substantial surpluses in that Social Security account. The problem that you identify is not going to get better, it's going to get worse.

Mr. DORGAN. If I may make one final comment. The surpluses are by design and there are surpluses now to meet estimated costs later. The point that I am making is that the current situation puts Social Security in an awful bind, but those folks are expecting the resources. We changed the age and the outyears—we made some tough decision in Social Security reform—in order to deal with Social Security problems.

We have doubled the defense budget and we have put enormous strains on the operating side. Now we are using Social Security taxes that we collect, to offset those expenditures. That is fundamentally dishonest and it's going to cause an enormous problem for us in fiscal policy.

Congress or the executive branch or probably both has to work to try to figure a way out of this bind, because it is surely going to be an enormous problem in the coming 4 to 5 years.

Mr. MILLER. Well, let me say that while it is an issue that we surely need to address, it is not an issue that is of recent making. Tracing back to the Greenspan Commission, decisions were made that the Social Security trust funds, which can only invest in instruments of the U.S. Government, would generate substantial surpluses over the next couple of decades. In fact, that was by design. So the problem that you identify is a problem that has been some time in the making and was predictable.

Mr. DORGAN. Only several years.

Mr. Chairman, if I might, just one final point. This is not something that's drug on over a decade. This is something that has been created from the reform commission and the action we took, which is just several years old.

Mr. MILLER. Right.

Mr. DORGAN. So it is not something that's an old problem. It's brand new and we need to deal with it.

Chairman ROSTENKOWSKI. Mr. McGrath will inquire.

Mr. MCGRATH. Thank you, Mr. Chairman, and thank you, Mr. Director, for coming and testifying and giving us your views today.

I really don't have many questions regarding this. I would like to point out, though, that last year in the reconciliation bill, we did away for a year with the phantom income tax on mutual funds. I was very happy to see that your permanent solution is to do away with the phantom income tax on mutual funds and that you included it as part of your budget. I'm gratified to see that. There are 20 cosponsors on this committee who are interested in making that fix permanent, 11 Republicans and 9 Democrats.

We'd be willing to work with you in order to effect that kind of change.

I ask, Mr. Chairman, unanimous consent to advise and extend my remarks and that my statement be placed into the record on this hearing.

Chairman ROSTENKOWSKI. Without objection, so ordered.

Mr. MCGRATH. Thank you.

[The statement follows:]

STATEMENT OF HON. RAYMOND J. MCGRATH, COMMENDING THE ADMINISTRATION FOR INCLUDING THE MODIFICATION OF I.R.C. SECTION 67(c) THE REMOVAL OF "THE PHANTOM INCOME TAX", IN ITS BUDGET PROPOSAL

I want to take this opportunity to commend the Administration for including in its budget proposal the elimination of the "phantom income tax" on mutual fund shareholders.

I am proud to be a lead sponsor with Congressman Matsui of H.R. 3375 which is designed to prevent mutual fund shareholders from being required to pay taxes on income they never received. This legislation is clearly not a narrow special interest provision—it affects almost 20 million Americans, including over 2.5 million in New York.

The adverse impact of this provision is broad and the support for changing it is likewise broad and bipartisan: 20 members of this Ways and Means Committee, including 11 Republicans and 9 Democrats are cosponsors of the corrective legislation. The provision was passed by the House in its original reconciliation bill last year and reported by the Senate Finance Committee.

I am confident that with the Administration's help, we will be able to eliminate this inequitable tax—permanently—this year.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Director, on the outside possibility that productivity rates don't increase to the extent that you predict, has your Department prepared any figures that would show the recall of a status quo productivity?

Mr. MILLER. Well, we have revised downward our estimates of economic growth for calendar year 1988. This would have the most effect, because it would start the wedge that goes into the fiscal year. Calendar year 1988 includes one quarter of fiscal year 1989 and also sets the baseline for the rest of the year. We revised downward our estimate from 3.4 percent economic growth to 2.4 percent, a full point revision. In fact, I think it was 3.5 down to 2.4. percent. And we think that's going to hold. And so status quo would have been an assumption of a higher level, or a status quo would be the economic growth rate that we experienced last year, which was around 3.8 percent.

So, no, we have not made any calculations based on these assumptions—to my knowledge, lately anyway. We have the facility to insert different assumptions into the so-called HITS model that we run and see how they play out. I'm sure there are people in OMB who have done that, but at a policy level, we have not said, well, let's assume, you know, consistent with what somebody else says, that economic growth is going to be lower and then tried to estimate the effects on the deficit.

Mr. COYNE. So you've just ruled out any possibility of a status quo percentage for productivity?

Mr. MILLER. Well, the status quo percentage for output growth would be 3.8 percent, and the deficit would be a lot lower, not higher, than we've estimated in this budget.

Mr. COYNE. What sectors of the economy do you think will show the greatest productivity increase?

Mr. MILLER. Well, we will have continuing, I think, across-the-board productivity increases. We expect, extrapolating from prior performance, solid productivity growth in manufacturing, and we anticipate some growth, as I've indicated in an earlier colloquy, in the export markets.

Mr. COYNE. In order for that to take place, would you anticipate heavy capital investment?

Mr. MILLER. Well, as you know, Congressman, it's hard to increase productivity immediately even with heavy doses of capital formation. I mean, it takes a while to put capital into place and for it to have an effect. So our assessments are based pretty much on what has gone forward in the investment and capital formation area in recent years.

Mr. COYNE. What about human capital? Do you——

Mr. MILLER. Human capital is very, very important. As you know, Congressman, I think the greatest advances that we make in productivity come from human capital rather than physical capital, and that's one reason that the President's budget and Secretary Bennett and others have given such important play to education and why we so desperately need to improve our local institutions, primary and secondary school education.

Mr. COYNE. Thank you very much.

Mr. MILLER. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman. Mr. Miller, good to see you again.

Mr. MILLER. Good to see you.

Mr. PICKLE. Mr. Miller, HCFA appeared before our committee and testified that Medicare part B premiums by January 1 have risen to a level of 38.5 percent. And they say that one of the larger reasons for that is because of increased costs by physician charges, which was only 13.5 percent. I personally think that's sort of an inaccurate analysis to imply all of the increase of premiums is due to physicians. There have been increased physician payments, but we used surplus funds we had as a contingency and didn't raise the premium for the last 2 years, and all at once we cannot avoid a big increase.

But the fact is, the premium has gone up enormously. Now, it seems to me that we face a problem for hospitals. The hospitals are now facing a negative margin on their Medicare cases, and that is now a fact.

You're proposing in your recommendation that you take 70 percent of these additional savings from part A, not part B but part A. Why take 70 percent of this additional savings out of part A, if the cost have gone up in part B?

Mr. MILLER. We disagree with the assessment that hospitals are losing money on Medicare patients for a number of reasons that I'll be glad to go into at more length in a written response to your question, Mr. Pickle.

Basically——

Mr. PICKLE. Well, Mr. Miller, I don't want to argue the point. They did have a little surplus, but that's been going down, and they say they're facing a negative margin. It's a very serious statement they're making. And essentially they may be correct. Yet you want to make most of the savings from the hospitals when they're facing difficulty. Isn't that strange?

Mr. MILLER. Well, no, it's not. Again, we are engaged in some overpayments to hospitals. As I indicated earlier, the payment to teaching hospitals is very high. The actuaries have indicated that the rebasing was called for. While there has been some squeezing of the excesses, we believe, in the hospitals, there are still some savings to be made.

Now I realize there are some differential effects, and we'd be glad to discuss with you the effects on rural versus city hospital, inner city hospitals, et cetera.

Mr. PICKLE. Well, I find it a little hard to accept. You want to make the savings in the part A, and you want to take most of that money, that savings, out of the indirect hospital teaching program, at least $700 or $800 million of it.

You've already cut the rate we have from about 9-something, nearly 9, 8-point-something, down to 7.6. Now you're going to make another 1- or 2-percent cut.

Mr. MILLER. No. Down to 4.05. A substantial cut.

Mr. PICKLE. Well, it seems to me like you're trying to single out one program as against the others. I don't know what the answer

is, but I don't think that it is clearly justified that that's where the major cuts ought to be.

Mr. MILLER. Well, of course, you have to look at where the major expenses are. I mean, the hospital expenses are a much larger portion of the total Medicare budget than are physician payments. Teaching hospitals have the highest Medicare operating margins of any class of hospital—13 percent. Nearly half of this is attributable to indirect medical education payments. But we do have, as I indicated in my testimony, some recommendations that would result in lower payments for what we believe are really excessively billed services by physicians as well.

Mr. PICKLE. Well, now, I was going to ask you if you could suggest any areas in which physicians' expenditures could be controlled.

I won't ask you at this point, because they must be lengthy, but you have some suggestions.

Mr. MILLER. Yes, sir.

Mr. PICKLE. I would ask you to submit that to the committee, because we'd like to hear it.

[The following was subsequently received:]

Question. Could you suggest any areas in which physicians' expenditures could be controlled?

Answer. The Administration is quite concerned about the excessive growth in physician spending. The President's budget assumes that program contractors will intensify their screening of bills for physician services. The Department of Health and Human Services (HHS) is pursuing a variety of physician payment reform options including research on procedure definitions, payment system options, and physician service volume and intensity issues. One particularly promising approach that HHS intends to evaluate for its ability to limit increases in physician reimbursement would be modeled after the innovative, private sector "preferred provider organizations".

Mr. PICKLE. Now I want to make one other comment. This is more of a commentary.

Based on the question the chairman and Mr. Duncan had asked you, you already made the statement that we were $1.5 billion short on the savings.

According to our Ways and Means staff, OMB estimated that the Medicare savings in the House-passed Reconciliation Bill to be $500 million in 1988 and about $900 million in 1989. Now as I understand it, OMB estimated that the Medicare savings in the final reconciliation bill at $4.2 billion.

I don't understand how you're saying now that you are cut out of negotiations, you didn't have a part of it, and yet if you had been in there and if you had given a vote on the conference instead of an advisory capacity, then you'd have made less savings than we would. Now you contend that the problem is because we didn't give you a voice and didn't follow OMB.

It seems to me like between what the chairman said and what you have said, there's just such a variance that somebody's going to say, "Well, where is the truth," and we keep asking ourselves.

It seems to me like if they had followed your recommendation they'd have actually saved less than the figures show. Is that correct or not?

Mr. MILLER. I don't think so, Mr. Pickle. I'd be more than happy to look at or discuss with your staff those figures. I think that our

estimates and our estimating methodology has been perfectly consistent throughout the past year. So I would say that I think the chances are not very high that following our advice would have saved less than the committee actually saved.

Mr. PICKLE. Well, I would just make the statement that the additional savings in the final bill really met our targets and I'm just asking you, is that correct or not, and you say——

Mr. MILLER. That's not correct.

Mr. PICKLE. You just don't think so.

Mr. MILLER. The savings fell short of the amounts agreed to in the negotiation in our judgment.

Mr. PICKLE. Well, the facts, as we have it, indicate that what you've said is not correct. Now where is the truth? I guess we don't know.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Brown will inquire.

Mr. BROWN. Mr. Miller, I want to commend you. You've come up with some forecasts for the coming year and economic assumptions that have met universal disapproval. And, yet, I understand Congress is going to adopt them. That demonstrates extraordinary persuasiveness on your part.

Mr. MILLER. I'll put that on my resume. And tell my children.

Mr. BROWN. I thought it might be helpful just to walk through them. We're 2½ months into the year now that you forecasted. Maybe you could help us evaluate where we are so far.

Now, I notice, in terms of unemployment, you forecast a 5.8 percent rate for the year. Is it 5.7? Is that my recollection? Is that correct?

Mr. MILLER. Yes.

Mr. BROWN. So, you're doing a little better than what you forecast on unemployment.

Mr. MILLER. We're doing better on unemployment. We're doing better on inflation rates and interest prime rates.

Mr. BROWN. Your interest rates are a little better than what you forecasted there? I see you have 5.3 percent for 3 month T-bills.

Mr. MILLER. Yes.

Mr. BROWN. What about real growth? Do you have any indication thus far?

Mr. MILLER. Well, it's kind of an interesting thing on real growth. Of course, the fourth quarter came in at much higher than we had anticipated. If you look at Blue Chip, you will see that what they have been doing has been moving, generally, in that direction.

These figures aren't exactly comparable, because we use fourth quarter to fourth quarter and these are year to year. But we're at 2.4 percent real GNP growth, and Blue Chip has moved from 2.2 to 2.4 for calendar year 1988.

Mr. BROWN. Now, I see Blue Chip listed here for 1988 as 1.8 percent. But you're saying their latest——

Mr. MILLER. The March 10 issue of Blue Chip—and, again, this is an average of some 50 forecasting organizations—lists year to year growth, at 2.4, up from 2.2. I don't have the previous issue with me, but they were below 2.0 at one point.

Mr. BROWN. Well, at this point, is it fair to say you're very comfortable with these estimates?

Mr. MILLER. Yes. Yes, I am.

Mr. BROWN. The Joint Tax Committee has a bulletin they put out on February 29, on the summary of the President's revenue proposals. Item nine is a repeal of the crude oil windfall profits tax. It notes the adjusted price base, which is significantly higher, at which point, they begin the windfall profits tax.

Those adjusted price base levels are significantly above current crude oil prices.

Mr. MILLER. Right.

Mr. BROWN. And, yet, the forecast indicates a repeal of the windfall profit tax reduces revenue. How is that possible?

Mr. MILLER. Well, it doesn't. At this point we see that the oil prices are at such a level that we do not believe that repeal of the windfall profits tax would reduce revenue at all.

Mr. BROWN. Is there savings in the repeal? Is there a significant drop in the number of reports that are filed and paperwork that is required?

Mr. MILLER. That is true. There's a reduction in some deadweight costs because of reports and that sort of thing. But I think, more importantly, the reason to end it is in order to provide incentives for people to explore and to maintain capacity in that industry.

So, if we have another problem with energy, we'd be better prepared for it.

Mr. BROWN. Earlier, you mentioned that the President's proposals were revenue neutral when they were balanced out. And some of us on the committee had made unkind references to the propensity of the administration to propose revenue enhancement.

Page 14 of this report indicates that the net effect of your tax provisions is about an $8 billion increase over the next 5 years. Am I misreading this? Do you have any comment? Is that within the range of being revenue neutral?

Mr. MILLER. No. We would disagree with that assessment. I'd be more than happy to look at the report, if you would give us a copy and we could take a look at it.

Mr. BROWN. Sure. I'd be glad to pass one up right now. Let me ask, though, if you have someone who might be willing to take a look at that.

I looked through the provisions, the revenue proposals of the President, searching for a provision that would reduce the tax rate on capital gains, and I didn't see it. Did I miss that? Was that in there?

Mr. MILLER. No. The President has indicated his support for reduction in the capital gains tax as part of any subsequent revision of the Tax Code. He does not advance a reduction in the capital gains rate as part of this budget.

Mr. BROWN. Does that mean you're not opposed to it, if we should come up with that as part of the tax package? Or part of it.

Mr. MILLER. Well, I would say that we would not oppose it if you generated it. But, again, I think we have to be careful about opening the Tax Code.

Let me say, if the other package here were enacted, and that, too, were enacted, I would certainly recommend to the President that he sign it.

Mr. BROWN. Thank you. The reference that I made was on page 14. I appreciate that you may want some time to look at that before you comment.

Mr. MILLER. Yes.

Mr. BROWN. But if you do have some comments, I thought they might be appropriate for the record. And I'll yield back, Mr. Chairman.

[The following was subsequently received:]

While the source cited on p. 14 is the U.S. Department of Treasury, the estimates of the President's proposals presented on the table are *not* what was printed in the budget. Treasury's estimates of the receipts proposals in the President's 1989 budget are printed below. Because the customs duty proposal results in increased outlays as well as increased receipts, the *net* deficit impact of the proposals must be considered.

As shown, in 1989, the Administration's proposals are *deficit* neutral. For the six year period, 1988–93, the proposals result in a net deficit reduction of only $0.3 billion. I believe that this is well within the range of being deficit neutral.

[In billions of dollars]

	1988	1989	1990	1991	1992	1993	1988–93
Receipts increase	0.3	0.7	0.9	1.2	0.9	0.8	4.8
Outlays increase	0.7	0.7	0.7	0.8	0.8	0.8	4.5
Net deficit reduction (−)	0.4	(1)	−0.2	−0.4	−0.1	(1)	−0.3

1 $50 million or less.

Mr. ROSTENKOWSKI. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. Mr. Miller, I appreciate your being here this morning.

First, let me take the opportunity to really commend the administration for including in its budget proposal the permanent elimination of the phantom income tax on mutual fund shareholders. I think that was an important step.

As the committee is well aware, code section 67(c) would have required those shareholders to pay a tax on income they literally have never received. There are almost 1 million people, shareholders, in that situation in Texas alone. So, it's an important step and I'm glad we could take care of it.

Let me, also, now turn to the Medicare provisions. I did not hear your original testimony. I apologize, first of all, but I would like you really to explain a little bit.

How do you justify that Medicare, which comprises about 9 to 10 percent of the total Federal budget, should take about a third of the budget cuts? Please correct me if I'm wrong.

Mr. MILLER. What we agreed to last November was the subject of extraordinary negotiations. And it is my recollection that we had about $6 billion of reductions in entitlement programs. And we had about $8.2 billion of reductions in the defense budget. And we had a $5.8 billion reduction in nondefense discretionary spending and pay. In defense and nondefense discretionary spending, the total reduction was nearly $14 billion. The entitlement reduction was $6 billion. Of that $6 billion, about $3.5 billion was in the Medicare area. It was the subject, again, of great negotiations as to where these savings could be realized.

Mr. ANDREWS. Well, now, let's follow up on Congressman Pickle's questions to you about hospital profits. What, in your view, is an acceptable profit margin for a hospital? Ten percent? Four percent?

Mr. MILLER. Well, define margin. Is it rate of return on equity? Is it rate of return on investment? Is it rate of return? Or, is it simply the operating ratio.

Mr. ANDREWS. It's not fair for you to ask the questions.

Mr. MILLER. Well, the difference is——

Mr. ANDREWS. Let's talk about operating costs.

Mr. MILLER. Well, I don't have the figures in my head that would translate. What you really want to do is to approximate them on a free market basis. That is, to have the hospital realize on these Medicare patients a rate of return that's about the same as their rate of return for non-Medicare patients in a competitive marketplace.

Now, the market of hospitals is very complicated. It has a lot to do with their various interests. Some hospitals earn very high rates of return. There are transitory factors. There are factors having to do with just unexpected caseloads. And this sort of thing.

But what you need to focus on is the rate of return on investment. So many of the figures that I have seen have been in terms of rate of return on the margin. Rate of revenues over total expenses. How much revenues per year exceed total expenses.

Well, if the turnover rate is very high, you can have a very low operating margin and a very large return on investment. Now, I'm not saying that, but it does cause us to look at this issue very closely.

Also, there's the real question of how you allocate those costs. If you're a hospital, how do you allocate costs to Medicare patients and to non-Medicare patients?

Mr. ANDREWS. Let me read a statistic to you, and just ask you to comment about it. In 1985—that's the year, I guess, of the highest reported profits on hospitals, the second year of PPS—the average hospital profit was about 14.2 percent. That was a good year for hospitals.

In 1987 the average profit had dropped to about two percent. Hospitals in my district—I represent the Texas Medical Center, and there are probably more hospitals in one square mile than anyplace in the country, I guess—let me read to you what they estimate their profit margins will be in 1988.

For Methodist Hospital, a $15 million loss.

For Hermann Hospital, a $1 million loss.

For St. Luke's Hospital, a $21 million loss.

The Harris County Hospital District, which includes social welfare, indigent hospitals, Ben Taub and Jeff Davis, they estimate in 1989 about a $1.4 million loss. A profit in 1988; a big loss in 1989.

Memorial Care System, which is a group probably not untypical of a lot of chains around the country, a $1.7 million loss.

Now, I'm not being accusatory about it. I'm really curious about this dilemma we face in terms of public policy. What are we going to do about this? How are we going to address this problem?

These people, I'm sure, are contacting the administration, just like they are members of the Ways and Means Committee.

Mr. MILLER. Right.

Mr. ANDREWS. Regardless of what you use, operating costs, equity, they—hospitals—are going to be under severe stress in the next 3 or 4 years. And I want your thoughts about it.

Mr. MILLER. Basically, what has happened is that some rebasing has been done by the fact that the PPS update has been only 25 percent of the inflation index.

Now, the relevant question is whether we've overshot. I don't believe we have, on national average. The Medicare actuary would be the better person to talk to about that.

If you have high reimbursements even high-cost hospitals or hospitals that experience a particular shift in case load will be OK because there's enough money for everybody. But when you bring it down to some level that's more comparable with a normal rate of return, they're going to be outliers.

There are going to be hospitals that find themselves in that kind of problem. That's the problem when you have an overall standard that's not fine-tuned.

I think it would probably be very useful for us to discuss in more detail how to go about fine-tuning the system. Where we provide incentives for efficiency, but we also respond to unusual circumstances. And I know this is something that's plagued the committee for a long time.

But as we do find ourselves closer and having hospitals realize more of a normal rate of return, it's going to dog us for some time.

Mr. ANDREWS. Well, I appreciate your comments. My time is up. And I really hope we have an opportunity to explore what is really a desperate situation for many of the major hospitals in the country.

And, obviously, our concern—and I'm sure you share it—is the quality of care that is going to result from these kinds of major, major losses.

Mr. MILLER. Absolutely. Sure.

Mr. ANDREWS. Thank you. Thank you, Mr. Chairman.

Mr. GIBBONS [presiding]. Thank you.

Mr. Frenzel.

Mr. FRENZEL. I would like to go back to some of the questions posed by Mr. Brown and Mr. Pease.

You indicated in response to Mr. Brown's question that you feel comfortable with your predictions in light of recent economic data. Certainly for the calendar year 1989, your estimates stick out like sore thumbs.

You tell me the Blue Chip people are now up to 2.4 on percent GNP growth for 1989?

Mr. MILLER. 1988. We're at 2.4 percent, and they are also in 1988. It is not exactly comparable, because ours is a fourth quarter over fourth quarter, and the Blue Chip is a calendar year.

Mr. FRENZEL. You were careful to explain that. My figures for Blue Chip is 2.2 for 1989, which makes you 60 percent above them.

Mr. MILLER. Now, Mr. Frenzel, I think the 2.2 figure was last month's figure. I'm reading from the March 10 issue of the Blue Chip report.

Mr. FRENZEL. Okay. And what is that?

Mr. MILLER. It's 2.4. It was 2.2 last month, and this month it's 2.4.

Mr. FRENZEL. I'm talking about the 1989 forecast.

Mr. MILLER. Oh, I'm sorry. The 1989 forecast. They are at 2.2, up from 2.1 percent.

Mr. FRENZEL. Yes. Which makes you 60 percent above them?

Mr. MILLER. Yes.

Mr. FRENZEL. And in the——

Mr. MILLER. But not in the—excuse me. I'm sorry. I didn't mean to interrupt.

Mr. FRENZEL. The Consumer Price Index, your projections for 1989 are 20 percent below them?

Mr. MILLER. Well, they're at 4.6 now.

Mr. FRENZEL. OK. I have them at 4.7 percent and you at 3.9 percent. You're substantially below them, if they've altered to 4.6 percent.

For 3-month Treasuries, without going through the notes, I have you 25 percent below them; and for 10-year Government bonds, more than 20 percent below them; and for the unemployment rate, about 9 percent below them.

We are told by the academicians that in diversity there is richness, but you are pretty diverse on this one. You indicated that you used the same methodology each time.

Can you tell us where your methodology or your estimates are likely to have differed substantially with the Blue Chippers?

Mr. MILLER. Well, you read out some differences in the estimates. As far as methodology—

Mr. FRENZEL. What led you to estimate figures so much different than theirs.

Mr. MILLER. Let me tell you what our methodology is. I cannot replicate the methodology of the blue chippers. The blue chippers are 50 forecasting agencies, and I daresay they range from people who are extremely good at back-of-the-envelope calculations to people who have economic models that require practically a Cary computer to run the algorithm.

But basically what we do is, we have models, and we have surveys that we read and we get inputs from various component parts of the Government. We draw on the Bureau of Economic Analysis at the Department of Commerce. We have the Council of Economic Advisers. We have the work of the Budget Review Division and the Economic Policy Division of the Office of Management and Budget. We have access to all the analysts at the Department of the Treasury. And what we do is, after considerable discussion at staff level and discussions at essentially our deputy level, the Chairman of the Council of Economic Advisers, the Secretary of the Treasury, and the Director of OMB sit down and go over the information and discuss it with our associates and with each other. We decide on a particular forecast for the near term, and then we make certain assumptions for the outyears.

That's the way we came up with our forecast for last year, and that's the way we came up with our forecast for this year.

I daresay again, it would be very hard to categorize the Blue Chip methodologies, because they're very broad. Polynomics is a noted outfit of considerable quality that has been associated with the supply side perspective. There are others here that are tradi-

tional Keynesians, and there are people that are noted monetarists. So it differs by which group you're talking about.

Mr. FRENZEL. All right. But you do agree that your estimates for calendar 1989, which embraces most of the fiscal year we're now working on, are substantially more rosy than theirs.

I'm going to ask my question a little differently than Mr. Pease.

Mr. MILLER. But, Mr. Frenzel, could I point out something that's very important. I'm not trying to be argumentative. But the Blue Chip is an average of a very wide divergence of opinion. I would just give you sort of just highs and lows.

On economic growth for calendar year 1989, year over year, the estimates range from a high of 4.5 percent, which is considerably higher than our estimate, down to a low of −1.7 percent. So you see there's a very broad range of estimates, and when you talk about Blue Chip, you're talking about the average estimate over quite a substantial——

Mr. FRENZEL. Well, I'm glad you pointed that out. I think that most people here understand that.

The question, Mr. Director is, when you are faced with snapshot time, are you going to use the same assumptions that underlie your budget submission that we have before us?

Mr. MILLER. We will use the same assumptions if there has been no changes in the economy that warrant our changing those assumptions. I would guess, however, that the assumptions that we do come up with for the August snapshot will be slightly different than those that we agreed to last December because we'll have more information.

For example, the unemployment rate has fallen and is below what we had anticipated its being. And that, everything else being equal, would lead us to revise upward our rate of growth assumptions for calendar year 1988. There may be some other offsetting things on the other side.

So I just can't tell you right now. But overall, if the economy performs as well as we believe it will perform, then we would have no reason to change our bottomline estimate of the deficit.

Mr. FRENZEL. I see. And supposing the deficit for the year that is about to end is higher than the previous year? That won't cause you to change any of your assumptions?

Mr. MILLER. Well, 1988 to be higher than the previous year would mean that something about the economy had been different than we assumed. That would probably change the fiscal year 1989 deficit estimate of as well. It's just a matter of arithmetic, I think.

Mr. FRENZEL. I don't know the wagering laws in the District of Columbia, so I'm not going to bet you on that deficit. But if it turns out to be less than last year, get ready to enjoy a big dinner at my expense.

Mr. MILLER. Thank you. I look forward to it.

Mr. GIBBONS. He eats well, too, Mr. Director. [Laughter.]

Mr. Director, the Canada-United States free trade arrangement looks like it's going to become law. If it does, there will be 10 months of tariff reductions in this budget that we're talking about now.

Your budget submission did not take that into consideration. I wonder, have you looked at the amount of tariff we will lose or you can comment on that.

Mr. MILLER. That's a very good point, Mr. Gibbons. Yes, we've looked at that. I don't recall the numbers in the back of my head right now. I'd like to get back to you.

Mr. GIBBONS. Could you supply for the record a figure, because as you know, we must take that into consideration in our budget projections for this year.

Mr. MILLER. Yes, I know. Yes.

[The administration's response to this question is included in the answer to question No. 6 of followup questions sent to Mr. Miller. See p. 45.]

Mr. GIBBONS. Canada is among our largest trading partners. But our rates toward Canada are relatively low, so I don't think that the impact will be too great, although there will be some impact there.

Mr. Downey?

Mr. DOWNEY. Thank you, Mr. Chairman.

Mr. Director, if we could go back to one of Mr. Brown's questions, I just want to get it clear in my mind.

The administration has proposed a variety of tax changes, many of which I agree with, and Mr. Brown asked you if you were in favor of a capital gains rate reduction. And I took your answer to mean that in the event that we do some of these other things, that the administration would be predisposed towards some sort of capital gains rate reduction. Is that a correct summary of what you told Mr. Brown?

Mr. MILLER. Well, let me say it again. Let me put it in my words.

Mr. DOWNEY. Yes. This is not an adversarial question. I just want to get it clear.

Mr. MILLER. No, no. I know. Let me say, the President has said that he supports a reduction in the capital gains tax as an idea, and he would encourage Congress in its next round of making changes in the tax laws and tax reform, perhaps envisioning a bigger, more fundamental change than anything we're talking about here, to include capital gains.

We are not advancing it now. There's not a proposal in this budget to reduce capital gains. We're not advocating that the Congress do it this year; that is, we're not mounting a proposal and trying to lobby Congress to do it this year.

On the other hand, I think the question was—or the way I put it to Mr. Brown—if Congress endorsed this package of revenue changes, but in addition on its own initiative reduced the capital gains rate, I said that I would personally recommend to the President that he sign the bill, and I suspect that he would be in favor of that.

Mr. DOWNEY. Let me develop this a little further. Can you give me a range of capital gains rate reductions that you would recommend to the President that he sign?

Mr. MILLER. Well, I don't want to say too much about that right now. I think getting the capital gains, returning it to its earlier levels——

Mr. DOWNEY. 20 percent.

Mr. MILLER. And perhaps even lower, I don't know. I would just have to take a look at it.

I do have a feeling, however, a very strong notion, that based on the kinds of analysis that I have seen prepared that a reduction in the capital gains rate would do two things that I think are positive for us in a sense.

One, it would stimulate investment and stimulate expansion of our economy, and secondly, it would actually increase receipts of the Government, rather than reduce them.

Mr. DOWNEY. So is it your contention, then, that if we were to reduce capital gains rates—and let's be realistic about where we were—would go with it—down to 20 percent, which was the level it was prior to the 1986 Tax Reform Act, that the studies that you have seen indicate that the dynamic of that would actually result in an increase in revenue as opposed to a decrease?

Mr. MILLER. That's correct.

Mr. DOWNEY. Well, can I further—I mean, the logic of this is interesting to me. Obviously if we took it to zero, there would be some problem in terms of revenue, wouldn't there?

Mr. MILLER. Well, I'd be glad to diagram it on the board, if you bring a board in.

Mr. DOWNEY. No, no. I mean, it's just the idea that you continue to lower rates, it increases revenues.

Mr. MILLER. Well, I think we both know if you reduce the tax rate to zero, you get zero revenues.

Mr. DOWNEY. Right. So that ideally the rate would be 1 percent, and you'd——

Mr. MILLER. No, I didn't say it would be ideally 1 percent. I didn't say it ideally would be 5 percent.

Mr. DOWNEY. See, it's this thinking that causes me some concern, because I happen to think that there should—we should not have raised capital gains rates. I personally believe in a differential.

It seems to me, however, that we wind up in a difficult theoretical position by continuing to make the argument that lowering the revenue—lower the rate will increase the revenue. I mean, at some point, it seems to me, that there is a diminishing return there.

Mr. MILLER. Well, Mr. Downey, I think it's inescapable that if you diagrammed it, a zero rate would get you zero revenue, and a 100 percent rate is going to get you zero revenue. Between those two extremes, relevant question is not necessarily where the optimal tax lies, but what are total receipts as a function of the tax rate.

Of course, if you have a different rate structure, the curve moves all over the place. But I think there's good empirical evidence suggesting that reducing it back to the previous level would result, everything else equal, in an increase in receipts, not a reduction in receipts.

Obviously, reducing the rate from 20 percent to zero would wipe out the receipts altogether.

Mr. DOWNEY. Right. But what happens——

Mr. MILLER. Although, if I could just add, I mean, it might have a stimulative effect that would——

Mr. DOWNEY. In other ways.

Mr. MILLER. In other ways, yes.

Mr. DOWNEY. I believe the current estimate of the Joint Tax Committee, however, is at variance with that, and I think even the Treasury Department is, with the administration indicating that they take a look more static and, I suspect, a more conservative approach, saying that a reduction of 8 percentage points might mean in the next few years a loss of revenue.

Would the administration still be interested if Treasury and Joint Tax indicated, as opposed to your analysis of some of the empirical data, that there is some loss in revenue, that you would still urge the President to sign it, if the net result was that there would be a revenue loss?

Mr. MILLER. Well, Mr. Downey, that's a hypothetical that does not square with the conclusions I draw from the analysis. So I simply don't want to answer that kind of question.

Mr. DOWNEY. Okay. So your position is that if we reduce capital gains and it increases revenue, the President signs it, and you're not prepared to speculate, although you've just done that, because I think that your analysis there is fairly speculative, but if the Joint Tax and Treasury show that it reduces revenue, you don't want to speculate on that?

I mean, explain to me the difference here. If it raises revenue, the President signs it, and if it loses revenue, he doesn't sign it?

Mr. MILLER. I just told you what I would do, Mr. Downey. I would conclude on the basis of the analysis I have seen—I might change my mind based on other analyses that I do not know about right now—but based on the analyses I have seen, I would conclude that a reduction in the capital gains rate would increase receipts and that would be one of the things I would consider——

Mr. DOWNEY. That would be one of the requirements?

Mr. MILLER. No, not necessarily a requirement. It would be one of the things I would consider. But having drawn that conclusion and drawn the conclusion also that a reduction in the capital gains rate would increase economic activity, I don't see any real down sides to lowering the capital gains rate and, therefore, if the Congress were to lower the capital gains rate from the existing level to the 20 percent level, I would recommend, from my own personal views, that the President sign the bill.

Mr. DOWNEY. I think that is clear. What I would like to ask you about is something that I asked you about once when you came before the Subcommittee on Welfare Reform. I see my time is sadly up so I won't ask you this question.

Mr. GIBBONS. Mr. Gregg?

Mr. GREGG. Thank you, Mr. Chairman.

Could you get us the backup or any documentation that you have relative to your conclusions that capital gains would generate an increase in revenue? There are a lot of us on this committee who would agree with that theory. If you reduce the rates, you clearly generate an activity in the marketplace which you are not going to get with higher rates. Therefore, you generate tax as a result of that activity. I would very much like to see any information you have which supports that.

Mr. MILLER. I would be glad to provide it for the record.

[The following was subsequently received:]

Revenue Effects of Changing the Capital Gains Tax Rate

Investors can defer paying taxes on capital gains until the assets are sold. This ability to defer taxes creates a "lock-in" effect. The length of the periods during which assets are held depends heavily on the rates at which capital gains are taxed. Revenue from taxes on capital gains is determined by the level of realized long-term capital gains, as well as by the applicable marginal tax rates.

Almost all previous studies, including the most recent one by CBO, conclude that raising the capital gains tax rates will reduce long-term gains realizations, and vice versa. There is, however, some disagreement about the magnitude of this effect. If it is large enough, revenues would actually fall when the tax rate on capital gains was raised; conversely, revenues would rise when rates were lowered. If the effect is small, however, revenues will move in the same direction as tax rates are changed.

Although empirical results are mixed, there are several studies which suggest that the effect on realizations is strong enough that lower tax rates on capital gains actually increase revenue. One of the earliest studies of this nature was undertaken by Feldstein, Slemrod and Yitzhaki (1980). Using cross-section analysis, they found that a reduction in the top rate on capital gains in 1973, from 45 percent to 25 percent, would raise revenues. They also found that eliminating the exclusion for long-term capital gains (which raises the effective rate) would lose revenues. In other words, revenues would move in the opposite direction of tax rate changes, especially when there are large changes in tax rates. This effect is also more likely to manifest itself when the tax rate is relatively high.

The Treasury Department (1985) simulated the revenue effects of the capital gains tax reductions in 1978 and 1981 using cross-section analysis. It found that, in both cases, revenues were raised as a result of the lower capital gains tax rates. Mixed results were obtained from using time series analysis. The time series studies provided a lesser response of realizations to rate changes; simulations using these results found that the 1978 rate reductions resulted in higher revenue, whereas 1981 reductions lost revenue.

A recent study by Lawrence Lindsey (1987) also concludes that lowering the capital gains rate will raise revenues. Lindsey's estimates are based on the econometric results of several independent investigations of capital gains realizations and tax revenue. A total of thirteen sets of behavioral assumptions -- derived from the major studies in the literature -- are modelled by Professor Lindsey. In effect, these are alternative estimates of the responsiveness of taxpayers to changes in the capital gains tax rate. For each of these various estimates of taxpayer sensitivity, Lindsey simulates the most likely revenue senario using the National Bureau of Economic Research TAXSIM Model.

Reproduced below are the relevant results from Lindsey's Table 2. Under four of the five behavioral assumptions presented, the revenue maximizing rates implied by the simulations are below the rates currently in effect. The precise capital gains tax rate that would yield the maximum revenue remains an open question. However, these results indicate that it is less than the current rate of 28 percent. This suggests that some reduction in the present rate would generate revenue increases. Conversely, there is scant evidence to suggest that a reduction in the present capital gains tax rate would cause revenue losses.

Behavioral Assumptions and Revenue Maximizing Tax Rates

Econometric Investigation	Implied Rev. Max. Rate
Feldstein, Slemrod and Yitzhaki	9%
Treasury Report on 1978 Tax Cuts	12%
Lindsey	18%
Auten-Clotfelter	21%
Minarik	28%

References

Martin S. Feldstein, Joel B. Slemrod, and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains," Quarterly Journal of Economics, vol. 94 (June 1980), pp. 777-791.

Office of the Secretary of the Treasury, Office of Tax Analysis, Report to Congress on the Capital Gains Tax Reductions of 1978 (September 1985), pp. 157-185.

Lawrence B. Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," National Tax Journal (September 1987).

Mr. GREGG. Second, do you folks have in your estimates here any analysis—we have been trying to get it from Treasury and Treasury has given us some very superficial thoughts on it—as to the revenue impacts of the drop in the stock market in October.

Mr. MILLER. I guess mainly as a result of the crash last October, we did revise downward our economic growth assumptions from 3.5 to 2.4 percent. I would be glad to work on that and get back to you with anything more refined.

Mr. GREGG. With the January estimated tax filings, there is some belief that possibly there was a significant amount of capital gains taken, and that since the market is still higher than it was in December of 1987, that a lot of the drop in the market in October was a locking in of gain, not taking of a loss. That would translate into increased revenues.

I am just wondering if there is a revenue blimp here.

Mr. MILLER. Mr. Gregg, we follow fairly closely the returns. Treasury is able to give us figures shortly after the end of every month on what has come in. What we have so far comports pretty much with the track we estimated the economy would follow in terms of total receipts and in terms of total outlays as well. We haven't noticed any blimp.

Mr. GREGG. I am fascinated as everyone else who has asked you questions here about these economic assumptions. One of the few things I remember from my educational experiences was a statement made by a fellow named Raymond J. Saulnier, who was the Chief Economic Adviser under Eisenhower. He told us one time that they did their economic assumptions in 1958 and later when he was walking home that night he saw that the new Chevrolet cars had come out with the big fantails. The next day he reevaluated his economic assumptions and changed them all.

I am wondering if you folks have checked the automobile inventory and other substantive sources?

Mr. MILLER. I would prefer a 1957 Chevy convertible, red, straight stick. I would love to have one. If I could quickly lay my hands on one, it might even change our assumptions.

These are the kinds of anecdotes that I think professors love to repeat to students about the times they were in Government. I suspect Mr. Saulnier was just looking for an excuse to push his assumption one way or another in his own mind. I don't think we have done that sort of——

Mr. GREGG. Although we have a more sophisticated economic assumption process, now this whole budget process this year has basically become a game of assumptions. It always has been a game of assumptions in the past, but this year it is even more a game of assumptions.

Where have we made any reductions in spending from the prior year in our budget?

Mr. MILLER. In this budget, there are individual elements for which there would be reductions in spending. We proposed a substantial reduction for EDA, elimination of UDAG, and other things of this nature that would reduce spending in specific areas. Overall, spending will increase. Total spending will increase in each of the major categories.

One reason that we have to have some reductions in spending in UDAG and things of this nature is in order to finance the increased spending in areas of priority, drug law enforcement, drug treatment, education, science, the space station, and other things such as this.

If I could just give you some indication, overall, we anticipate from 1988 to 1989 in this budget, outlays increasing by 3.9 percent. For example, the total program outlays will go up from $953.4 billion, not counting interest, undistributed offsetting receipts, and asset sales, to $990.2 billion. Outlays will go up. For national defense, outlays will go up by 3 percent. For international affairs, it will go down 1 percent. Domestic discretionary spending will go up by 5.3 percent. Entitlements and other mandatory programs will go up about 4 percent.

Mr. GREGG. You also have, as I understand it, $10 billion of asset sales; is that correct?

Mr. MILLER. That's about right.

Mr. GREGG. When we get to this summer and push comes to shove on the Gramm-Rudman estimates and the Gramm-Rudman situation, asset sales can't be accounted for.

Mr. MILLER. We estimate the deficit will be $129.5 billion including the asset sales. As you know, under Gramm-Rudman-Hollings, to determine whether a sequester is called for, you have to excise certain of these asset sales and you have to make some more adjustments that are very complicated. When you do that, we come in with a baseline figure of $142.7 billion, which is what has to be compared with $146 billion.

Right now, with the President's budget, we come in under the trigger for a Gramm-Rudman-Hollings sequester. On the other hand, the margin is sufficiently narrow that if the economy deteriorated in any significant way, then we would trigger a sequester.

Mr. GREGG. Rather than sequester, what would you recommend in reconciliation to reduce——

Mr. MILLER. Mr. Gregg, at this point I just wouldn't want to speculate on what it would be. The reason is I don't think there is any useful dialogue that can take place: (*a*) I don't believe we are going to trigger sequester, and (*b*) I think a dialogue on that right now would be counterproductive. It would divert us away from the task at hand which I thoroughly believe is for both ends of Pennsylvania Avenue to commit to carrying out the deal that we made last November.

If in the context of that deal, come August, it turns out we are over the sequester trigger, I think, as I indicated earlier, it would behoove us all to sit down and see where we could come up with additional savings to avoid a sequester, which I think would be in no one's real interest.

Mr. GREGG. Thank you. If I could get that information on the capital gains, I'd appreciate it. Thank you.

Mr. GIBBONS. Mr. Vander Jagt?

Mr. VANDER JAGT. Thank you very much, Mr. Chairman. Thank you, Director Miller, for a very clear and understandable testimony on a complex and confusing subject of interdependent parts and often times changing parts.

Mr. MILLER. Thank you, sir.

Mr. VANDER JAGT. The administration's economic forecasts are rosier than CBO's and many of the blue blue chip forecasters. It may not be rosy enough. In the USA Today, the Chairman of the Federal Reserve, Alan Greenspan, speculates that unemployment may hit 5.2 percent this year instead of the 5.8 percent that you project. That worries him because then employers will start competing for employees and that may mean inflation.

Can you give me any general observations on the accuracy, say, of your forecast for 1987 compared with CBO's or some of the blue chips forecasters?

Mr. MILLER. For 1987, we were not optimistic enough. CBO was much more pessimistic. CBO was not as optimistic as we were and it turned out that we were not optimistic enough. The economy grew at faster rates than we had projected, and inflation rates were below those that we had projected. The deficit came down by an extra $25 billion from what we projected this time last year.

Mr. VANDER JAGT. You were closer to hitting the target because you were more optimistic than CBO?

Mr. MILLER. That's right; we were.

Mr. VANDER JAGT. Thank you very much. Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. Director, we are all very sensitive about that $146 billion sequester figure. I hope that you will do all you can because it seems that when we get the Gramm-Rudman figures backed out of your estimate, really what we are talking about is your estimate of $142.7 versus $146. We are only about $3 billion off that target, which puts us pretty close.

Mr. MILLER. That's right.

Mr. GIBBONS. We need as much advance warning as you can give us, if you feel we are going to go over that $146.

Mr. MILLER. That's fair enough.

Mr. GIBBONS. We would just ask you to do that. I would ask you, and I hate to ask you these kinds of questions, what is the probability you would give the committee based on what might happen between now and July 15, that we could hit this $146 or below, assuming that the Congress has done all the appropriate things, like get the bills passed and things of that sort? Can you see any trend developing?

Mr. MILLER. I am reluctant to quantify it because I——

Mr. GIBBONS. I understand. Do the best you can.

Mr. MILLER. I think when we put the numbers together last December, which was the predicate for the budget, we felt comfortable about those numbers then. We feel more comfortable now, because the data that have come in since then in terms of the resurgence of exports, in terms of the lower unemployment rates, in terms of the lower rates of inflation, in terms of the lower prices of energy, have all led us to be more sure of those assumptions than we were last December.

Mr. GIBBONS. It is helpful to know that. We appreciate it. We are often pictured in the press as being combative and sometimes we are. Generally speaking, we want to do the right thing. We just need as much advance warning from you as you can possibly give us.

Mr. MILLER. We will do that.

Mr. GIBBONS. I would rather have you call fire too soon than too late.

Mr. MILLER. Yes, sir.

Mr. GIBBONS. Thank you very much. We appreciate the fine testimony you have brought us today.

Mr. MILLER. Thank you. It's been my pleasure, sir.

[The following are questions submitted to Mr. Miller and responses recevied from OMB:]

1) Not counting asset sales and the proposed medicare cuts of $1.2 billion, what would the deficit projection be for fiscal year 1989 under the Administration's recommendations, using Gramm-Rudman-Hollings scoring rules?

The outlay and receipt proposals contained in the President's budget would result in an estimated deficit of $129.5 billion in FY 1989. This FY 1989 deficit estimate includes asset sales and prepayments of $10.0 billion, which cannot be counted under the Gramm-Rudman-Hollings scoring rules, and a proposal to reduce Medicare by $1.2 billion below the G-R-H baseline level. By removing these two deficit-reducing proposals from the budget, additional interest costs of $0.4 billion would also be incurred in FY 1989. In total, therefore, the FY 1989 deficit would rise to $141.1 billion if asset sales and the Medicare savings proposal were excluded from the budget totals.

2) One of the purposes of the amended Gramm-Rudman law was to make the budget process a little simpler and more understandable. The statute defined a baseline against which the President's and Congress' policy recommendations could be compared. Why did OMB ignore this statutory baseline? What is the difference between the baseline you used and this statutory baseline? For example, why is the extension of the authority for IRS to collect non-tax debts part of current services and not part of the President's recommendations? Other expiring tax provisions are not in the current services baseline or the statutory baseline, and are part of the President's recommendations. Why the inconsistency?

The budget documents include discussions of both the current services and the Gramm-Rudman-Hollings (G-R-H) baselines, as required by law. While the two baselines are closely related, our interpretation of the statute allows some differences. Part 6A of the President's budget discusses the two baselines and explains why the administration prefers to use the current year as the base to judge policy proposals.

The differences between the current services and the G-R-H baseline can be summarized as follows: (1) Unlike the G-R-H baseline, the current services estimates include specific loan prepayments enacted in the 1988 Continuing Resolution and the Omnibus Budget Reconciliation Act of 1987. (2) Current services incorporates the levels for discretionary programs specified in the Bipartisan Budget Agreement while the G-R-H baseline adjusts all discretionary programs for inflation and increased pay-related costs, as required by the G-R-H Act. (3) Current services estimates assume that clearly temporary discretionary programs will end as scheduled while the G-R-H baseline estimates, as specified in the G-R-H Act, assume continuation of these programs. (4) The current services baseline includes an extension of IRS authority to collect non-tax debts that is not part of the G-R-H baseline. These collections were handled in this manner -- rather than making them part of the President's recommendations -- because the authority has already been extended once by the Congress and further extension was considered fairly certain. Other expiring provisions of tax law that are routinely reauthorized are treated in a like manner.

3) According to CBO projections, average real growth per enrollee in the Hospital Insurance program will fall by 1/2 of 1 percent between 1985 and 1989. In light of this negative growth, what justification is there for another $1.0 billion in spending cuts in this program?

There are two reasons that additional reductions in the growth of Medicare are required. First, the Medicare savings targets of $2.0 billion in FY 1988 and $3.5 billion in FY 1989 agreed to in the Bipartisan Budget Agreement have not been met. Administration pricing by the Medicare Actuary of the final Medicare provisions of the reconciliation bill indicate a shortfall of $1.2 billion. Second, Medicare spending is growing rapidly and threatens the future solvency of the trust funds. At current

rates of growth, total Medicare spending will exceed spending for either Social Security or Defense by 2010. The 1987 Medicare Trustee report indicates that the Hospital Insurance trust fund will be exhausted in 2002. Although the Trustee reports finds the Supplemental Medical Insurance trust fund financially sound in the immediate future, it cautions:

"Growth rates have been so rapid that outlays of the program have doubled every five to six years, and this growth shows no sign of abating despite recent efforts to control the cost of the program. The Board recommends that Congress continue to work to curtail the rapid growth in the supplementary medical insurance program."

4) According to my staff, OMB estimated the medicare savings in the House-passed reconciliation bill at $500 million in fiscal year 1988 and $900 million in fiscal year 1989. As I understand it, OMB estimates medicare savings in the final reconciliation bill at $4.2 billion for fiscal years 1988 and 1989 combined. Thus, the additional savings in the final bill were much greater than $500 million per year. Is that correct? Please provide a detailed (provision by provision) accounting of the medicare provisions in the House-passed reconciliation bill and the final reconciliation bill (P.L. 100-203).

With all of last year's action on Reconciliation and the Bipartisan Budget Agreement, a fair amount of confusion about various savings estimates still exists. The Ways and Means Commitee (using Congressional pricing) projected Medicare savings of approximately $1.5 billion in FY 1988 and $3.0 billion in FY 1989. The Administration's scoring was much lower. Last winter, some members maintained that in order to meet the targets agreed to in the Bipartisan Summit Agreement ($2.0 billion in FY 1988 and $3.5 billion FY 1989), only $500 million was needed in FY 1988.

Anticipating the complexity of scoring Medicare and other mandatory programs, the Agreement required that "CBO and OMB shall work together to resolve scoring methodology problems on mandatory accounts." Both CBO and the Administration wrestled with estimating over thirty, constantly changing Medicare sections, many having multiple provisions. Late in the Conference Committee deliberations, Congress decided to rely on CBO pricing for Medicare, rather than work out the significant scoring differences. Beyond being inconsistent with the Agreement, it was also inconsistent with Congress' practice in other conference areas such as Agriculture, where Adminstration pricing was more favorable. As a result, CBO concluded that the Reconciliation bill met the targets set by the Agreement (FY 1988 $2.0 billion and FY 1989 $3.8 billion), while the Administration concluded that the bill fell short (FY 1988 $1.7 billion and FY 1989 $2.6 billion).

5) Under the Administration recommendations, the deficit declines from $129 billion in fiscal year 1989 to $23 billion in 1993. Setting the Social Security trust funds aside, the deficit declines from $194 billion in fiscal year 1989 to $137 billion in 1993. From an economic point of view, is it correct to include the Social Security trust fund surplus in the deficit estimate, or should we set it aside and look at the remaining deficits?

From both a budget accounting and an economic point of view, the Social Security trust funds, and all other trust funds, should be included in calculating Federal Government outlays, receipts, and deficits.

The Federal budget is the financial plan for the United States Government. It displays the totality of Federal taxes and spending, and it provides a system to control them. The budget seeks to show what resources the Federal Government is taking in and what the Government is doing with these resources. This basic accounting principle was set forth in the 1967 Report of the President's Commission on Budget Concepts. In its report, the Commission stated that its most important recommendation is the

adoption of the unified budget -- a budget that is "comprehensive of the full range of Federal activities." It said explicity: "Specifically, the budget should include the transactions of the Federal trust funds . . . ." The reason for this recommendation flows from the nature of Federal trust funds.

What the budget labels as "trust funds" are not trust funds in the private sector use of that term. In private finance the term "trust fund" refers to money held in a fiduciary capacity by a trustee. In Federal finance "trust fund" only means that a program has three characteristics: (1) it is a Federal Government program; (2) it involves earmarked money; and (3) it is labeled a "trust fund" by law. Trust fund income may be composed of earmarked taxes or other forms of receipts. These receipts may derive from user charges, but in some cases they do not, coming instead from the public or from other Federal Government accounts. Regardless of the source of the income, the process of the Government collecting and disbursing monies through trust funds occurs as an integral part of the Government's fiscal operations. To exclude them from deficit estimates would imply that Social Security and other trust fund taxes are not really Federal taxes and that their spending is not really Federal spending -- despite the fact that they were established by Federal law, have been changed many times by Federal law, depend on the sovereign powers of the Federal Government to collect tax receipts, are run by Federal officials and Federal employees, are under the supervision and control of the President and the Congress, and carry out policies that are universally accepted as the responsibility of the President and the Congress.

True, under current law, the two Social Security trust funds, unlike all other Federal activities, are off-budget. This status provides Social Security with an insulation from having to compete with other programs in the on-budget decisionmaking process. However, the fiscal impact of the Social Security trust funds is immense, as the funds account for more than a quarter of all Federal receipts and spending. Hence, the budget adds the on-budget and off-budget components to arrive at total Federal receipts, outlays, and surpluses or deficits. This provides a comprehensive record of the totality of Federal fiscal activity.

Any analysis of the effect of the Government on the economy must include Social Security outlays and receipts. They are part of the Government's operations, and they have important economic effects. They affect aggregate demand, income distribution, and incentives, just as do other kinds of Government taxation and spending. For the same basic reasons, the Federal deficit also needs to include Social Security activities. The deficit is the amount by which Federal spending exceeds receipts from the public, and measures the amount of spending to be financed by Federal borrowing from the public or other means of financing. This is the amount by which the Federal Government must tap the private capital markets and draw on private savings. Excluding the Social Security surplus from the deficit total would seriously misstate the financing requirements of the Federal Government and the Government's other impacts on the economy.

It should be clear that the inclusion of the trust funds in calculating the Federal Government totals, including the deficit figures, in no way impairs the integrity of the trust funds. No impairment occurred from 1968 to 1986, when Social Security was on-budget, and no impairment has occurred since 1986, when it has been added to the on-budget amounts in obtaining deficit totals for the Federal Government. The budget clearly accounts for each trust fund as an entity, thereby permitting policy decisions concerning a particular trust fund to be based on an analysis of that individual fund, while still identifying the composite of total receipts, outlays, and surpluses or deficits. Additionally, inclusion of trust funds in the budget does not -- by itself -- require that the Congress control the trust funds through the budget process. The Congress can, if it so chooses, exempt any trust funds it wants from the control mechanisms it enacts. But it should not exempt them from being counted -- we need to see and evaluate the totality of Federal fiscal activity.

6. The President strongly supports the U.S.-Canada Free Trade Agreement. I understand that the loss in revenues (tariffs) and Customs Service user fee receipts could total several hundred million dollars in fiscal year 1989. Why wasn't this included in your budget submission? What is the precise revenue loss (including any change in user fee receipts) from the U.S.-Canada Free Trade Agreement?

Response

The President's Budget included the following estimates of receipts from customs duties and customs user fees:

	($ in billions)				
	1987 (actual)	1988	1989	1990	1991
Customs duties	15.1	16.4	17.2	18.3	19.2
Customs user fees	0.5	0.7	0.6	0.5	0.5

The President's Budget, through its economic forecast of net exports and imports, does implicitly take into account the combined effects of proposed legislation to make the user fee GATT-consistent and to implement the U.S.-Canada Free Trade Agreement (FTA), although the effects of the FTA are not separately identified.

Our estimate of duties foregone, shown in the table below, is an estimate of direct costs only. It is subject to the limitations that these estimates do not reflect second-order effects (e.g., impact on duties collected from third countries; expansion of trade with Canada as duties are phased out; revenue increase due to economic growth resulting from increased trade flows).

	($ in billions)				
	1989	1990	1991	1992	1993
Gross duties foregone ..	0.1	0.3	0.4	0.5	0.7
Income tax offset 1/ ...	-*	-0.1	-0.1	-0.3	-0.3
Net receipts foregone ..	0.1	0.2	0.3	0.2	0.4

* Less than $50 million.

1/ Increased income tax deposits due to higher taxable income.

The FTA provides that starting on January 1, 1990, the U.S. must cut by 20 percent each year the customs user fee on goods qualifying under the rule of origin of the FTA. The fee on Canadian goods will be eliminated as of January 1, 1994. Neither country may introduce new customs user fee programs to pay for the costs of Customs administration on goods from the other country.

The Administration estimates the impact on receipts of this provision as follows:

	($ in billions)				
	1989	1990	1991	1992	1993
Reduction in Customs user fee receipts	--	*	*	0.1	0.1

* Less than $50 million.

ATTACHMENT A

IMPORTS FROM CANADA = $68,431 million in 1987

1985 BASE CASE ESTIMATES

		Duties Collected (millions)	Duties Foregone (millions)
BASE YEAR	(1985)	$613	$0
YEAR 1	(1989)	$469	$144
YEAR 2	(1990)	$388	$226
YEAR 3	(1991)	$303	$311
YEAR 4	(1992)	$221	$392
YEAR 5	(1993)	$146	$468
YEAR 6	(1994)	$116	$497
YEAR 7	(1995)	$86	$527
YEAR 8	(1996)	$57	$556
YEAR 9	(1997)	$27	$586

Comments:

1. All calculations apply agreed staging tariff reductions to the base year ad valorem equivalent tariff rate.

2. Calculations are based on "standard" stagings of immediate, five-year, and ten-year. The two commodities staged over three years beginning in the second year are correctly handled.

3. The "exceptions" to the standard rounding are not recognized. All staging reductions follow the standard rounding rule.

4. The "delayed staging" categories have been treated by assumption: three quarters of first year trade at the base rate and one quarter of the first year trade at the "first year" rate.

5. Replacement auto parts: for the specified items within Chapter 87, half of the reported trade is assumed to be after-market auto parts and is staged at five years, while the other half is staged as agreed for that item. Outside Chapter 87, all trade is staged as agreed for that item (i.e., it is assumed that there are no after-market auto parts in those items).

ATTACHMENT B

1987 BASE WITH GROWTH IN TRADE

	Calendar Years		Fiscal Years	
	Collected Duties (millions)	Foregone Duties (millions)	Collected Duties (millions)	Foregone Duties (millions)
1989	$551	$169	$585	$127
1990	$484	$282	$501	$254
1991	$396	$407	$418	$376
1992	$315	$560	$336	$522
1993	$219	$707	$243	$668

Comments:

1. The 1985 base in Attachment A is adjusted upward to reflect actual growth in imports between 1985 and 1987.

2. The real value of imports from Canada for 1988 and subsequent years is assumed to grow at the same rate as total customs duties through 1991 and at the same rate as nominal GNP in 1992 and 1993.

3. All GNP and total customs duty assumptions are taken from the Economic Assumptions for the 1989 Budget.

4. The conversion from calendar years to fiscal years assumes that trade is evenly divided among the quarters in a calendar year.

ATTACHMENT C

Additional Details on Customs User Fees

(in millions of dollars)

	1987 (actual)	1988	1989	1990	1991	1992	1993
Receipts pre-FTA	539	662	560	561	568	573	578
Reduction due to FTA ..	--	--	--	-22	-46	-68	-92
Receipts post-FTA*	539	662	560	539	522	505	486

* These are the amounts in the President's Budget. They reflect both the impact of the FTA and the Administration's proposal to make the user fee GATT-consistent.

Mr. GIBBONS. Our next witness is Mr. James L. Blum, who is the Acting Director of the Congressional Budget Office. Mr. Blum, we would ask you to come forward.

You may proceed as you wish, Mr. Blum. We welcome you.

STATEMENT OF JAMES L. BLUM, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. BLUM. Thank you, Mr. Chairman. It's a pleasure to be here.

Mr. GIBBONS. I bet. Just like pulling a tooth. [Laughter.]

I noticed the way you shook all those hands. You could make a good Director over there. You have a good handshake, as well as a good crystal ball.

Mr. BLUM. Mr. Chairman, I have a complete statement which I would like to submit for the record.

Mr. GIBBONS. Certainly. Without objection, the statement will be accepted in the record.

Mr. BLUM. In the interest of time, I will summarize the highlights of the statement. The statement covers, for the most part, two reports that the Congressional Budget Office [CBO] has produced recently. The first one is the Economic and Budget Outlook, which contains our baseline projections. That's the rosy covered one. But I can assure you, Mr. Chairman, it does not have a rosy scenario inside the covers.

The second volume is our analysis of the President's budget for 1989, using CBO economic and technical estimating assumptions.

My statement covers first the CBO baseline projections. The important point is that CBO's baseline projections for fiscal years 1989 through 1993 follow precisely the specifications of the Balanced Budget Reaffirmation Act for the definition of the budget base. That means that our baseline projection for the deficit for fiscal year 1989 of $177 billion is the estimate that we would make in August if nothing else changed between now and then. That compares, for example, with the administration's estimate that you heard Mr. Miller present this morning of approximately $143 billion. So we have a $34 billion estimating difference for the baseline deficit for 1989.

CBO's baseline projection shows that the deficit would rise from $150 billion for the most recently completed fiscal year—1987—to $161 billion for the current fiscal year—1988—and then to $177 billion for 1989, before it starts to fall.

These baseline projections include the results of the actions taken last December by the Congress in the continuing resolution of appropriations for fiscal year 1988, as well as the effects of the omnibus budget reconcilation bill. By our calculation those two major legislative actions reduced the deficit by approximately $34 billion in 1988, and by approximately $36 billion in 1989, from what otherwise would have obtained.

CBO estimates that, under the summit agreement for 1989 by, additional deficit reductions must be made of approximately $7 billion, including $3.5 billion of asset sales. Such a reduction would lower the deficit for 1989, under our calculations, to $170 billion, well in excess of the Balanced Budget Act's deficit target for that year of $136 billion. For 1990, it would lower the baseline deficit to

about $160 billion, which is $60 billion more than the $100 billion deficit target that is specified by the Balanced Budget Reaffirmation Act for 1990.

Applying our economic assumptions and technical estimating methods to the administration's budget as submitted by the President last month, we calculate a deficit of $165 billion, compared with the administration's estimates of slightly less than $130 billion. So the estimating gap is over $35 billion. The CBO reestimates of the President's budget this time are relatively large, very large in comparison to the reestimates that we have made in previous years. Most of the reestimates result from the use of less optimistic economic assumptions. The CBO economic assumptions are quite close to the consensus of private forecasters as represented by the Blue Chip survey. They are less optimistic than the administration, as the committee understands. They are close to the Blue Chip not only for the forecast period, calendar years 1988 and 1989, but also for the longer run period through calendar year 1993.

Let me stop at that point, Mr. Chairman. I would be pleased to answer any questions you might have.

[The prepared statement of Mr. Blum follows:]

Statement of
James L. Blum
Acting Director and
Assistant Director for Budget Analysis
Congressional Budget Office
March 16, 1988

Mr. Chairman, I am pleased to appear before this committee to discuss the economic and budget projections of the Congressional Budget Office (CBO). These projections are described in detail in three reports that CBO has recently released: The Economic and Budget Outlook, Reducing the Deficit, and An Analysis of the President's Budgetary Proposals for Fiscal Year 1989. In my testimony I will summarize CBO's baseline budget projections, our analysis of the Administration's budget, and our short-run economic forecast and long-run economic assumptions.

CBO BASELINE BUDGET PROJECTIONS

CBO projects that the federal deficit would rise from $150 billion in 1987 to $161 billion in 1988 and $177 billion in 1989, if current budgetary policies are continued without change. CBO's base-line projections for federal revenues, outlays, and the deficit are shown in Table 1. The projected rise in the deficit largely results from the phase-in of the Tax Reform Act of 1986 and from various one-time outlay savings. Tax reform added substantially to revenues in 1987, but reduces tax collections in 1988 and 1989 compared with prior law. Asset sales, loan prepayments, and other one-time spending cuts enacted to date hold down outlays by $15 billion in 1987 and $7 billion in 1988, but they make no contribution to deficit reduction in 1989. Were it not for these special factors, the deficit would fall from 1987 to 1988 and would remain roughly level in 1989.

After 1989, the baseline deficit is projected to decline slowly from $177 billion in 1989 to $139 billion in 1993. The deficit shrinks because revenues are boosted by both inflation and real growth, while outlays rise only slightly faster than the rate of inflation. Compared with the size of the nation's economy, the baseline deficit falls from 3.6 percent of the gross national product (GNP) in 1989 to 3.2 percent in 1990 and 2.1 percent in 1993. The ratio of debt held by the public to GNP rises slightly through 1990 and falls thereafter.

As in past years, CBO's baseline budget projections assume that revenues, offsetting receipts, and entitlement spending are projected according to the laws now on the statute books. Defense and nondefense discretionary appropriations are assumed to be held constant in real terms. The non-pay portions of the 1988 appropriations are inflated by the projected rise in the GNP implicit price deflator (4.0 percent for 1989). Personnel costs are also inflated using the GNP deflator, but with adjustments for pay absorption and increases in retirement costs.

Last fall, the Congress amended the definition of the Balanced Budget Act budget base to make it conform closely to the traditional CBO baseline approach. Because the remaining differences were small--less than $200 million in 1989--CBO has made its new 1989 baseline identical to the baseline specified in the Balanced Budget Reaffirmation Act. We hope that this move will eliminate any confusion that resulted from having more than one baseline.

TABLE 1. CBO BASELINE BUDGET PROJECTIONS (By fiscal year)

	1988	1989	1990	1991	1992	1993
	In Billions of Dollars					
Revenues						
Individual income	390	415	455	495	533	575
Corporate income	99	107	119	126	130	134
Social insurance	331	352	381	408	433	465
Other	79	80	82	83	84	87
Total	898	954	1,036	1,111	1,181	1,261
Outlays						
National defense	287	295	306	320	333	346
Nondefense discretionary spending	176	193	203	207	215	222
Entitlements and other mandatory spending	500	536	573	610	650	694
Net interest	152	166	185	198	203	208
Offsetting receipts	-56	-59	-61	-64	-67	-70
Total	1,059	1,131	1,206	1,271	1,335	1,400
Deficit	161	177	170	159	154	139
Debt Held by the Public	2,046	2,222	2,391	2,547	2,700	2,838
	As a Percent of GNP					
Revenues						
Individual income	8.3	8.3	8.5	8.7	8.8	8.8
Corporate income	2.1	2.1	2.2	2.2	2.1	2.1
Social insurance	7.1	7.1	7.1	7.2	7.1	7.2
Other	1.7	1.6	1.5	1.5	1.4	1.3
Total	19.2	19.1	19.5	19.5	19.4	19.4
Outlays						
National defense	6.1	5.9	5.7	5.6	5.5	5.3
Nondefense discretionary spending	3.8	3.9	3.8	3.6	3.5	3.4
Entitlements and other mandatory spending	10.7	10.7	10.8	10.7	10.7	10.7
Net interest	3.2	3.3	3.5	3.5	3.3	3.2
Offsetting receipts	-1.2	-1.2	-1.2	-1.1	-1.1	-1.1
Total	22.6	22.7	22.6	22.3	22.0	21.5
Deficit	3.4	3.6	3.2	2.8	2.5	2.1
Debt Held by the Public	43.7	44.6	44.9	44.8	44.4	43.7

SOURCE: Congressional Budget Office.
NOTE: Totals include Social Security, which is off-budget.

Because the CBO baseline is a projection of current laws and policies, it incorporates only those elements of the budget summit agreement that have already been put in place. As shown in Table 2, last December's appropriation and reconciliation measures reduced the deficit by $34 billion in 1988 and $36 billion in 1989. A few further steps remain to be taken, however, to carry out the budget summit agreement in full. Adhering to the appropriation caps contained in the reconciliation bill would further reduce 1989 outlays from the baseline by roughly $1 billion in defense and $2 billion in nondefense programs. These savings arise because the CBO baseline for 1989 assumes more growth in discretionary appropriations than was provided by the summit agreement. The reconciliation bill also calls for selling an additional $3.5 billion of federal assets in 1989. Finally, $0.4 billion in revenues would result from further boosts in resources for Internal Revenue Service enforcement. These steps would bring the total two-year deficit reduction resulting from the budget summit to $76 billion--exactly on target.

TABLE 2. THE BUDGET SUMMIT AGREEMENT
(By fiscal year, in billions of dollars)

	1988	1989
Deficit Reduction Already Achieved		
Revenues		
Taxes	9.2	14.2
IRS compliance (gross)	1.8	2.5
User fees	-0.5	-0.6
Total	10.5	16.1
Outlays		
National defense	5.1	7.4
Nondefense discretionary	2.5	1.6
Entitlements and other mandatory spending		
Medicare	2.1	3.8
Farm price supports	1.2	0.9
Postal Service and Civil Service	0.8	0.6
Pension Benefit Guaranty Corporation premiums	0.4	0.4
Veterans housing loan sales and fees	0.8	0.8
Guaranteed Student Loan balances	0.2	--
Other	0.2	-0.4
Subtotal	5.7	6.2
Other user fees (offsetting receipts)	0.8	0.9
Asset sales and prepayments	7.7	--
Net interest	1.3	3.4
Total	23.1	19.5
Deficit Reduction	33.6	35.6
Additionnal Deficit Reduction to be Achieved		
Revenues--IRS Compliance	--	0.4
Outlays		
National defense	--	1.2
Nondefense discretionary	--	1.8
Asset sales	--	3.5
Net interest	--	0.3
Total	--	6.8
Deficit Reduction	--	7.2
Total Deficit Reduction		
Deficit Reduction	33.6	42.8

SOURCE: Congressional Budget Office.

Taking no action this year beyond that required by the budget summit, however, would leave the deficit well above the Balanced Budget Act targets. In 1989, the deficit would exceed the $136 billion target by $34 billion, according to CBO's current estimates. The problem would be even greater in 1990, when the deficit would exceed the $100 billion target by more than $60 billion.

THE ADMINISTRATION'S BUDGET PROGRAM

CBO's baseline projections provide a benchmark against which the Administration's budget program can be measured. Because the baseline and the CBO estimate of the budget employ the same economic and technical assumptions, differences between the two are solely the result of proposed policy changes. The Administration's budget would cut the projected deficits only modestly. CBO estimates that the Administration's budget proposals would reduce the 1989 deficit to $165 billion--$12 billion below the baseline level of $177 billion. The amount of deficit reduction grows to $13 billion in 1990, $19 billion in 1991, and $29 billion in 1993 (see Table 3).

TABLE 3. THE ADMINISTRATION'S BUDGET PROGRAM AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

	1989	1990	1991	1992	1993
CBO Baseline Deficit	177	170	159	154	139
Policy Changes					
Revenues a/	-1	-1	-1	-1	-1
National defense	-1	b/	1	3	5
Nondefense discretionary spending	-2	-2	-8	-12	-16
Entitlements and other mandatory spending	-3	-6	-6	-6	-6
Offsetting receipts	1	b/	-4	-4	-6
Asset sales and prepayments	-6	-3	b/	b/	b/
Net interest	b/	-1	-2	-4	-5
Total Policy Changes	-12	-13	-19	-23	-29
Deficit, President's Budget as Estimated by CBO	165	157	140	131	109
Deficit, President's Budget	130	104	79	51	23
CBO Reestimates					
Economic	25	41	59	75	86
Technical	11	12	2	5	b/
Total Reestimates	36	53	61	80	86

SOURCES: Congressional Budget Office; Office of Management and Budget.

NOTE: Totals include Social Security, which is off-budget.

a. Revenue increases are shown with a negative sign because they reduce the deficit.
b. Less than $0.5 billion.

Almost all of the proposed deficit reduction is on the outlay side. By adhering to the appropriation caps contained in the reconciliation bill, the Administration budget reduces defense outlays by $1 billion and nondefense discretionary spending by $2 billion in 1989 compared with the baseline. After 1989, defense budget authority would grow by 1 percent in real terms, based on CBO economic assumptions. CBO estimates that defense outlays would be close to the baseline amount in 1990 and would exceed the baseline by $1 billion in 1991 and $5 billion in 1993. Nondefense discretionary savings would remain at about $2 billion in 1990, and would grow to $8 billion in 1991 and $16 billion in 1993.

Entitlement reductions total $3 billion in 1989 and $6 billion per year thereafter, about a third of which would be in Medicare. Proposed changes in offsetting receipts would increase outlays by $1 billion in 1989, have little net effect in 1990, and reduce outlays by $4 billion in 1991 and $6 billion in 1993. The 1989 increase results primarily from a proposal to reclassify certain customs user fees as revenues rather than as offsetting receipts. Over the 1989 through 1993 period, higher premiums for Supplementary Medical Insurance account for about half of the proposed deficit reduction in this category.

Asset sales account for $6 billion, or more than half, of the 1989 deficit reduction. Slightly more than $3 billion derives from the prepayment and sale of Rural Electrification Administration and other loans. Sale of the Naval Petroleum Reserve and the Alaska Power Marketing Administration would yield somewhat less than $3 billion. Proposed asset sales contribute $3 billion to deficit reduction in 1990 and little thereafter.

CBO estimates that the federal deficit under Administration policies would be $165 billion in 1989, $157 billion in 1990, and $109 billion in 1993. These CBO estimates exceed the Administration's figures by $36 billion in 1989 and increasing amounts in later years, as shown in Figure 1. In 1989, $25 billion of the $36 billion in reestimates is attributable to differing economic assumptions, and $11 billion stems from technical estimating differences. In 1991 through 1993, virtually all of the reestimates are economic.

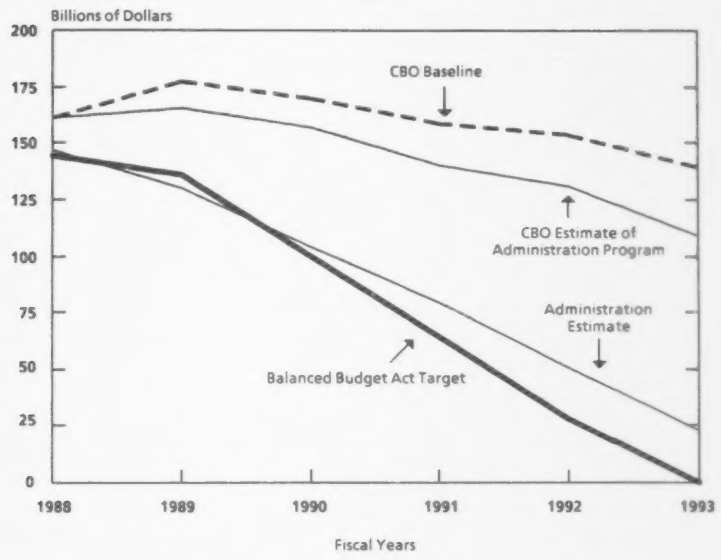
CBO ECONOMIC ASSUMPTIONS

CBO expects slower real growth, higher inflation, and higher interest rates during the next two years than does the Administration, as shown in Table 4. The CBO forecast for real growth is similar to the current consensus of private-sector forecasters. The somewhat better-than-expected gains in employment in the two months since the CBO forecast was prepared have not significantly changed private forecasts for real growth in 1988 and 1989, although many forecasters have raised their expectations for the current quarter.

The consensus forecast for consumer price inflation is lower than CBO's, perhaps in part because of lower projected petroleum prices. The recent weakness in oil prices tends to support this view, but prices remain volatile and could easily return to the level in the CBO forecast for 1988. For 1989, the CBO and the consensus infla-tion forecasts are similar.

While the Administration projects that the annual averages of short- and long-term interest rates will decline in 1988 and 1989, CBO and most private forecasters expect interest rates to rise in both years. The

Figure 1.
Federal Deficit Projections and Targets



SOURCE: Congressional Budget Office; Office of Management and Budget.

NOTE: Totals include Social Security, which is off-budget.

consensus forecast, however, does not have as rapid an increase as foreseen by CBO, particularly in 1988. This difference, as well as the difference between CBO's and the Administration's forecasts, roughly corresponds to differing views about inflation. CBO's inflation and interest rate forecast for 1988 assumes a further weakening of the dollar this year. While the dollar has been stable recently, continuing trade and budget deficits make CBO's forecast of a weaker dollar and higher inflation and interest rates a likely prospect.

Economic forecasting is anything but a precise science. Like all forecasts, CBO's has certain critical elements. For one thing, it depends on the success of the Federal Reserve in supplying the economy with enough credit to avoid a recession, without reigniting inflation or undermining the dollar. Consumer spending is assumed to grow slowly but steadily. Finally, the forecast assumes that the long-awaited improvement in net exports has finally arrived and will accelerate in 1988. On the other hand, the economy could prove stronger than in this forecast if consumers return to the abnormally low saving rates of the past few years.

How does the federal government's budgetary stance affect the risks to the forecast? The most commonly used gauge of discretionary fiscal policy is the standardized-employment, or structural, deficit--a measure that excludes the cyclical component of the deficit. This year the calculation should also exclude the nonrecurring effects of tax reform, asset sales, and other one-time outlay savings, which alter the pattern of the

TABLE 4. COMPARISON OF ADMINISTRATION, CBO, AND BLUE CHIP SHORT-RUN ECONOMIC FORECASTS (By calendar year)

	Actual	Forecast	
	1987	1988	1989
Fourth Quarter to Fourth Quarter (Percent change)			
Real GNP			
Administration	3.8	2.4	3.5
CBO	3.8	1.8	2.6
Blue Chip	3.8	1.8	2.2
Nominal GNP			
Administration	7.2	6.4	7.3
CBO	7.2	5.7	6.9
Blue Chip	7.2	5.5	6.7
Consumer Price Index a/			
Administration	4.5	4.3	3.9
CBO	4.5	4.9	4.8
Blue Chip	4.5	4.1	4.7
Calendar Year Averages (Percent)			
Three-Month Treasury Bill Rate			
Administration	5.8	5.3	5.2
CBO	5.8	6.2	6.7
Blue Chip	5.8	5.9	6.4
Ten-Year Government Note Rate			
Administration	8.4	8.0	7.4
CBO	8.4	9.3	9.5
Blue Chip b/	8.4	8.8	9.0
Civilian Unemployment Rate			
Administration c/	6.1	5.8	5.6
CBO	6.2	6.2	6.1
Blue Chip	6.2	6.0	6.1

SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (March 10, 1988). The CBO forecast is based on preliminary 1987 fourth-quarter data published in January 1988; the February revisions were small and are not included.

a. Consumer Price Index for urban wage earners and clerical workers.

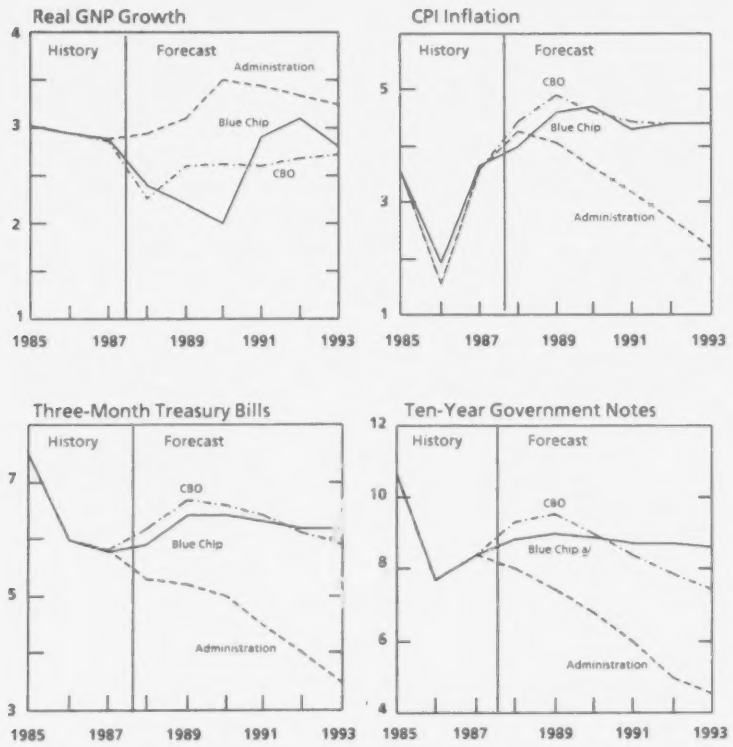
b. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the AAA bond rate, adjusted by CBO to reflect the estimated spread between AAA bonds and 10-year government notes.

c. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage points below the rate for the civilian labor force alone.

deficit but may have little effect on aggregate demand and employment. Assuming implementation of the budget summit but excluding these special factors, the standardized-employment deficit would decline by only 0.3 percent of potential GNP in fiscal year 1989. Because this represents very little fiscal restraint, and because we project that the economy will have regained its momentum by 1989, modest cuts in the 1989 deficit should not precipitate a recession. Moreover, while cutting the deficit would initially tend to reduce domestic demand, it would also allow a somewhat more expansionary monetary policy, and perhaps encourage more stimulative policies abroad.

Beyond 1989, neither CBO nor the Administration attempts to forecast the economy. Rather, both agencies make projections based on historical trends. As in the short-term outlook, CBO's long-run economic assumptions are less optimistic than those of the Administration but similar to those of the consensus of private-sector forecasters. Figure 2 provides a comparison of CBO, Administration, and Blue Chip economic assumptions.

Figure 2.
Comparison of Administration, CBO, and Blue Chip Economic Assumptions



SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (March 10, 1988).

a. *Blue Chip* does not project a ten-year note rate. The values shown here are based on the *Blue Chip* projection of the AAA bond rate, adjusted by CBO to reflect the estimated spread between AAA bonds and ten-year government notes.

The uncertainty inherent in these economic and budget projections increases as the time horizon lengthens. In our annual report, we have attempted to quantify this uncertainty using a statistical approach. We find that there are about two chances in three that the level of real GNP in 1993 will turn out to be within 7 percent of its projected value, or that the average real growth rate between 1987 and 1993 will be between 1.6 percent and 3.6 percent. As a result, there is a two-in-three chance that the 1993 deficit will be within $125 billion of its projected value of $139 billion. This large degree of uncertainty confirms that the longer-run projections should be viewed only as a general indicator of budgetary trends and not as a forecast of future budgets.

Mr. PEASE [presiding]. Thank you very much.

Mr. Duncan.

Mr. DUNCAN. I have no questions. Thank you.

Mr. PEASE. Mr. Blum, let me say that I very much appreciate your testimony, and I also appreciate the good work that CBO does. There must be some inverse correlation between the attendance of members at a person's testimony and the blue sky nature of the projections that that person is giving us. No one wants to stick around and hear you give your accurate projections, but everybody wanted to be here in the earlier part for Mr. Miller, to see if he could deliver with a straight face the estimates that he's been giving us for 1989.

I commend CBO for its record of greater accuracy over the last 7 years, much greater accuracy, I might say, than the OMB and the dose of realism which you are injecting into our discussion for next year.

You have had the advantage over OMB of making your estimate of the President's budget just recently, whereas the OMB projections were made, I guess, last December.

Have there been any changes, substantial changes, in the economy over the last two months which would substantially reflect or account for the differences between your estimate and that of OMB?

Mr. BLUM. CBO's economic forecast was put together largely during the month of December, about the same time as the administration's. Since that time, we have had approximately 2 months of new data. There have been some changes that are noteworthy.

Our forecast that we made in December looked to a pronounced slowdown in economic growth in the first half of calendar year 1988, with very sharp recovery in the last half. The information that has come in to date, particularly the employment figures for February, indicate that the slowdown is likely to be much shallower than CBO's projection. That also indicates to us that the recovery in the latter half of the year would not be as great, so that overall, we might still come out fairly close to our projection for real growth over the four quarters of the calendar year.

CBO's interest rate assumptions are clearly too high, at least for the first quarter. Interest rates have been much lower than assumed by CBO, but they remain quite volatile and it's hard to say exactly what that means for the remainder of the year.

CBO anticipated that interest rates would rise later in the calendar year, and there is no reason to expect that won't happen.

CBO expected the dollar to fall a little more than it has. The fact that interest rates were lower and that the dollar proved a bit stronger than CBO predicted for the first quarter of this calendar year is probably due to a massive purchase of the dollar by foreign central banks. Another possible underlying cause is the strong growth in the monetary base.

With respect to inflation, we are getting ambiguous signals. Oil prices clearly are lower than expected, but some other prices are higher, and it's too soon to tell exactly what will happen on the inflation front.

Mr. PEASE. Looking ahead to August, when the OMB is going to have to make its snapshot, if things proceed, the economy proceeds

about normally—well, if normal is such a word—normally for the next few months, then presumably when it comes to August and snapshot period, there will still be 40 some billion dollar difference between your estimates and OMB estimates of the deficit for fiscal year 1989; is that correct?

Mr. BLUM. That is correct. There very likely will be a major estimating difference between CBO and OMB in August.

Mr. PEASE. How difficult do you think it will be for OMB to maintain its current position, should it choose to do that, by August of 1988?

Mr. BLUM. That is a very difficult question to answer, because it would involve speculation on my part. If the economy continues to perform the way it has for the last 2 months, then certainly I would not expect OMB or the administration to change its economic assumptions much.

Mr. PEASE. Well, I hope that those who read about this testimony will look at your figures not only for 1989, but also for 1990. If I remember, if I recall your testimony correctly, you told us that even if the Congress adopts deficit reduction measures this year recommended by the President, that in 1990, you estimate there will be a $60 billion gap between the deficit and the Gramm-Rudman target; is that right?

Mr. BLUM. That is correct under the assumptions that we have used for our baseline projections.

Mr. PEASE. Well, I think all of us need to recognize that when the new President takes office in 1989, in January, he's going to have an enormous problem facing him because of our collective reluctance, not only the administration but also the Congress, to face up to reality this year.

Speaking of facing up to reality, I hope you people in CBO don't get a complex of some kind, but Mr. Miller and OMB don't seem to agree with you on anything. First they don't agree with you on the deficit targets or estimates for 1989 or 1990, and then Mr. Miller walks in here only a few days after you estimated the revenue loss from the capital gains differential, and says that he sees a revenue gain.

I presume that you stand by your estimates.

Mr. BLUM. Yes, sir. The CBO study that was released late last week, examining how a reduction in the tax rates could affect revenues, was a careful analytical study, looking at data over a 30-year period. The conclusions in that study carefully pointed out that there is a fairly wide range of uncertainty in the revenue estimates. It is clear that lowering the tax rate on capital gains would lead to an increase in capital gain realizations, but the results of the study point out that increased realizations are not likely to result in an increase in revenues.

Mr. PEASE. Quite the contrary.

Mr. BLUM. That's right. Depending on what the tax rate was lowered to—the study focused on the possibility of it going down to 15 percent—the results indicated that the loss of revenues could be on the order of $4 to $8 billion per year. This was a steady-state estimate for the long run. There obviously could be year-to-year differences, so I would not characterize that as our first-year estimate, but rather as a steady-state average over the longer run.

Mr. PEASE. I see. Mr. Miller made much in his testimony of the concept of equity, as he talked about some revenue measures in the current administration proposal.

You, in your recent study of the capital gains differential, concentrated, I think, quite properly on the revenue implications.

Have you made any study or could you offer any opinion regarding the income distribution impact of a capital gains differential rate?

Mr. BLUM. The study is quite clear in terms of the income distribution effects. Most capital gains are realized by people with higher incomes, and it is this segment of the taxpayer population that would benefit most from a reduction in the capital gains tax rate.

Mr. PEASE. So that the income distribution we worked out, I must say rather carefully, in fashioning the 1986 Tax Act would be adversely affected in terms of distribution if we were now to have a capital gains differential; is that a correct statement in your view?

Mr. BLUM. That is correct. The income distribution effects of a reduction of the capital gains tax rate are skewed toward the higher income groups.

Mr. PEASE. Mr. Blum, thank you very much for your testimony. As I say, we in Congress are extremely proud of CBO and the excellent work that it does. You serve us and the Nation well, and we're grateful for your testimony this morning.

Mr. BLUM. Thank you, Mr. Chairman.

Mr. DUNCAN. Mr. Chairman, I would like to ask one question.

Mr. PEASE. You may do so, sir.

Mr. DUNCAN. We're talking about optimism and pessimism, but how did the CBO miss so greatly last year on the estimates on revenues? I think it was something like $20 billion or something. Your most recent record isn't quite as good as you have had in the past. Of course, times change.

It was almost ridiculous the way CBO missed last year, and we must go on recent trends instead of past records.

Mr. BLUM. Frankly, Mr. Duncan, we were all surprised by the surge in revenues that came in last year largely as a result of the Tax Reform Act of 1986. We missed the boat in terms of how much capital gains realizations would increase in anticipation of the rise in the tax rate. As a result, revenues were a lot higher than either we, or, the administration, anticipated.

Mr. DUNCAN. But the administration had the better estimate, though?

Mr. BLUM. As Mr. Miller testified this morning, OMB's estimate of the 1987 deficit in January a year ago was, leaving aside $2 billion of rescissions, $175 billion. CBO's comparable estimate was practically the same, $176 billion.

Mr. DUNCAN. Have you made any effort at all to correct the way you make your estimates, since you missed the ball so far?

Mr. BLUM. We certainly try to learn from our experience.

Mr. DUNCAN. That's a little embarrassing. Thank you very much, Mr. Blum.

Thank you, Mr. Chairman.

Mr. PEASE. Thank you, Mr. Duncan.

Mr. Blum, on that point, I presume that you and your people would feel that last year was a bit of an aberration, since it involved a major change in tax policy and that you would not expect so much of a variation from now on out since the new tax bill is in place and should allow you to predict its effects more accurately.

Mr. BLUM. That's exactly right, Mr. Chairman. CBO is still, however, learning about the effects of the Tax Reform Act. I think it will take a year or two before we're completely confident of making an accurate estimate of the effects of that act.

Mr. PEASE. I'm sure that Mr. Duncan would want me to make the observation that the administration was so dreadfully far off in its optimistic projections of revenue growth from the effect of the 1981 Tax Act, it was probably reluctant to be optimistic at all in relation to the 1986 Tax Act, and that's why it came in at a somewhat lower figure.

Mr. DUNCAN. Well, I think that things have been so good in this country, the economy growing, high employment and other things, that it's fooled a lot of us. But we're happy with that. We're not pessimistic about it. And I'm sure that you wish also that Mr. Miller's projections prevail instead of yours, because it would be better. I think that we should not go back and look only at past years. We had a good record one year and a bad one another. CBO has had good records, but you were way off last year, and almost a backyard accountant could have probably done a little better.

I think that we've had good years and bad years, but we're all glad that the economy is doing so good. The projections now indicate that we're going to have higher—maybe full employment by the end of the year. To me, that is good, and I'm not a pessimist, and I'm always glad to see things are better.

Mr. PEASE. We can close on that note. All of us would agree that optimism is better than pessimism whenever appropriate. [Laughter.]

The committee is going to recess at this point. It will reconvene at 2 p.m. for further testimony from the Department of the Treasury and from a panel of economists.

Again, Mr. Blum, thank you very much.

Mr. BLUM. Thank you, Mr. Chairman.

[Whereupon, at 11:45 a.m., the committee was recessed, to reconvene at 2 p.m.]

AFTERNOON SESSION

Chairman ROSTENKOWSKI. Mr. Secretary, welcome to the committee. I am hoping that is the last of a series of rollcalls or quorum calls. We always look forward to your interesting testimony.

Unless Mr. Duncan has something to say——

Mr. DUNCAN. We are glad you are here.

Chairman ROSTENKOWSKI. Welcome, Don. Fasten your seatbelt.

STATEMENT OF HON. O. DONALDSON CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman. I hope that won't be necessary—such a friendly crowd here.

My testimony has been submitted in full for the record, but I would like to summarize it and answer any questions the members of the committee might have.

The President's budget presents no budget receipt proposals that are brand new concepts, that are brand new ideas or major in scope. We think we ought to give the system a rest and create a stable environment. We ought to keep the rates low and have continuity in the present tax law. If we emphasize that and leave the 1986 act in place for several years, maybe we can make it work.

However, we do need to adopt the technical corrections bill. There are a number of administrative and interpretive issues that are in the 1986 and now the 1987 act that need to be addressed. We think they are well addressed in the technical bill. There is very little controversy on that bill and we think that those matters should be addressed as soon as possible.

So we want to indicate at the outset our strongest possible support for early and prompt enactment of the technical corrections bill.

Let me turn now to the eight or nine specific proposals in the President's budget covered in my testimony.

The first is the college savings bond proposal, whereby a family could buy a U.S. savings bond to put aside money for the postsecondary education for their children. The money would go into the savings bond, it would not be taxed as the value built up, and when the money came out of the savings bond, the principal plus the interest, the interest would not be taxed if it were used for educational purposes such as books, tuition, and reasonable room and board.

We think this is necessary because of higher expenses for a college education. Our testimony specifically points out that private education costs have risen over 90 percent since 1980, public education costs have risen 70 percent since 1980, and we anticipate that over the next 19 years those costs will soar to $200,000 for a 4-year private college and as much as $60,000 for a 4-year public college. We think something needs to be done and that this proposal would be incentive for individuals to save for a college education.

The next item is make permanent a research and experimentation credit. The current credit will expire at the end of 1988. The administration considers it an extremely high priority to have this credit extended because the credit encourages research and experimentation. It is this sort of research, basic research, that is needed to protect the competitiveness of U.S. companies, both here and abroad.

We have heard from many individuals that there are suggestions to revise the credit, modify it, make it more cost productive, get more return for the tax cost of creating incentive for R&E; and if a proposal can be crafted that would make the credit more effective, we would support that too.

One suggestion would be to change the credit's floating base. Right now the credit has a 3-year base period, which floats each year to the preceding 3 years prior to the tax year. There might be some logic in making this base a fixed base, so that it would not float, so the taxpayers could know that their expenditures would qualify for the credit in comparison to that fixed base. We think it would be logical to have a minimum credit that a taxpayer could

elect—like a 2-percent credit, a very low credit—that he would get even if he did not qualify under the floating base credit or if he elected to go for the 2-percent credit rather than a calculation under the floating base. We think if anything of that sort is done, though, it should be done on a revenue neutral basis, which might require that any credit that is taken be used as a reduction in the cost basis of the property that is used, or that the R&E expenditures themselves be reduced by the amount of the credit.

The administration wishes to stress is that the R&E credit needs to be made permanent, so taxpayers can count on it, not only next year and the year after it but many years into the future.

Similarly, we propose to extend and revise the allocation of R&E expenses that expired last August. The 1986 act extended it for 1 year, until August 1987, providing for a 50-percent deemed allocation to domestic income. We propose that this allocation be made 67 percent, with the remaining 33 percent allocated in accordance with worldwide gross income or sales. This allocation method would not only encourage research and experimentation but it would encourage it to be done in the United States. It would be a fair method of making this allocation determination.

The next item on the list is the mutual fund shareholders' 2-percent floor rule. This provision was enacted in the 1986 act. It provided that miscellaneous itemized deductions could not be taken by taxpayers except to the extent that they exceeded two percent of their gross income. This rule was made applicable to mutual funds, but not to other flowthrough entities such as REITs. We think this has created a competitive disadvantage to mutual funds. We think that there is no sound reason for continuing this provision's application to mutual funds. It was extended, as you know, in the 1987 act for 1 years. A moratorium was put on it so that the 2-percent floor did not apply to public mututal funds through 1987, but that expired on January 1, 1988. We think that exception should be made permanent for public mutual funds.

We don't think that there is any real danger that individuals will invest in mutual funds just to get around the 2-percent floor. The reasons for investing in mutual funds are very sound ones. Small investors can receive good management, good advice and hopefully good returns on their stock investments by going to the mutual funds. That is the primary motivation. We don't see any effort to get around the 2-percent floor rule that would be raised by this proposal.

The next item is the repeal of the windfall profit tax. The administration has proposed this before, but at the present time the benefits of this current proposal are twofold. One, it costs no revenue now to repeal the windfall profits tax because the price of oil is well below the threshold price that must be reached before the tax raises any money, and, second, the oil industry is badly in need of incentives to explore and produce oil. The windfall profit tax, even when it does not raise any money, acts as a disincentive for investment for oil and gas exploration and development simply because investors, when they calculate the potential for future return on investments, must factor in the windfall profit tax. If the price of oil rises in the market place, this extra cost discourages this type of investment.

One other point that ought to be noted, and it is a very significant one, is that there is no windfall profit to be picked up, such as is contemplated by the windfall profit tax act. Any windfall that existed from deregulation of oil prices has been realized because the marketplace has driven the price of oil down below the price at which oil was when it was deregulated, and without the windfall, we think there is no continuing justification for this tax provision.

Also we propose two provisions related to the application of the depletion rules. The first is raising the net income limitation on eligibility for percentage depletion. The current law says that percentage of depletion cannot exceed 50 percent of net income from the oil and gas property. We propose changing that to 100 percent of the oil and gas property because this affects marginal wells and marginal production. There are many cases in which depletion cannot be effective because the marginal production is limited and taxpayers cannot be assured that depletion will not be limited by this 50 percent of net income rule. We think that is counterproductive and we encourage that that limitation be raised to 100 percent so that marginal production would be encouraged.

In the same vein, we propose that the transfer rule be eliminated. This provides that percentage depletion can no longer apply to a proven oil and gas property once it has been transferred from one taxpayer to another. Currently there are a number of marginal wells, primarily stripper wells, operated by major companies that are not entitled to percentage depletion and have no interest in continuing this marginal production because it is not cost-effective to do so. On the other hand, there are independent producers who are use to operating marginal wells. They could do so on a low cost basis, and if they could get percentage depletion, they would be happy to take the stripper wells off the hands of the large producers, operate them in a cost effective way, and continue this very desirable and needed production. Continuing of the transfer rule is counterproductive to keeping the stripper wells in place and we recommend that it be terminated.

The next item is the branch tax credit, which came into the tax law in 1986 and was imposed on the profits of a branch of a foreign corporation doing business in the United States. This tax is imposed as a withholding tax on the repatriation of the profits of the branch to the foreign company that owns the branch.

We think this rule is working well, except that it is an unfair if the foreign corporation is owned by a U.S. shareholder. In that case, the U.S. shareholder is subject to the withholding tax applied on the branch profits and also to a tax when he receives a dividend from the foreign corporation, which represents the same earnings that have already been taxed under the withholding tax. Incidentally, those earnings were taxed the first time under the regular corporate tax when they were earned and a U.S. corporate tax return was filed by the branch operating in the United States. So we have the regular corporate income tax and the withholding tax on the removal of the earnings from the United States, and then the U.S. shareholder is taxed a third time when he gets the earnings in the form of a dividend. We propose to eliminate this unfairness by giving the shareholder a tax credit for the amount of the branch profits tax that have already been paid on these earnings.

It would be a credit against the tax he would otherwise owe on the dividends received from the foreign corporation.

The next item is the customs user fee provision, which was enacted in the 1986 bill. It was a provision requiring that users of the Customs Agency's services in importing goods to the United States bear a share of the processing cost. However, it was imposed on an ad valorem basis; that is, on the basis of the value of the goods imported. This contrary to the GATT procedures because, based on the value of the goods, it does not necessarily relate to the cost that the Customs Service has to incur to process these goods.

We support revising this tax to reflect the cost the Customs Service incurs when it processes the goods. This would raise some $100 million in fiscal 1989 I believe, but the main purpose would be to solve the GATT problem that exists under the current customs user fee structure.

We also propose to modify the Superfund petroleum tax for a similar reason, and that is that the petroleum tax, which is part of the Superfund tax, imposes a different tax on foreign crude than it does on domestic crude. GATT has ruled that that violates the provisions of GATT and that we would be subject to retaliation, or penalties if this tax is continued. We think that, rather than run that risk, it's much better to revise the tax in a revenue-neutral basis, which would reduce the tax imposed on foreign crude and increase slightly the tax imposed on domestic petroleum to a flat 9.65-cents-per-barrel charge on both foreign and domestic oil. That would eliminate the GATT problem and be a fair resolution of this matter.

To pay for the proposals that would lose money, we're proposing several items, the most significant of which is extending of the Medicare hospital insurance coverage to state and local employees. This committee has addressed this proposal before, but we think it is worthy of consideration again. As the law now stands, employees hired after March 31, 1986, are included in Medicare coverage. Those hired before March 31, 1986, are not covered by Medicare and, therefore, are not paying their fair share of the burden of Medicare coverage, despite the fact that they are usually benefiting from it. Seventy-five percent of these employees are already covered by the Medicare provisions because of prior employment or because of coverage from a spouse. The remaining 25 percent are not covered and have no way of being covered, and they need this coverage and protection. We think this is a needed reform and would encourage this committee to reconsider the proposal to extend the Medicare to State and local employees.

There are two other items touched on in the testimony. One is the Nuclear Regulatory Commission user fees and the other is the Federal Emergency Management Agency user fees. Basically, both of these proposals contemplate that the nuclear power plants bear a larger share of the costs incurred by the Federal Government in regulating them, and, in the case of FEMA in acting as its agent in monitoring evacuation plans and other safety measures.

Right now, the nuclear industry bears 45 percent of the cost of the expenses that the NRC incurs. We would propose increasing it to 55 percent. In the case of the Federal Emergency Management Agency, none of those costs are currently borne directly by the nu-

clear industry. It is our proposal that user fees be imposed so that they would bear 55 percent of FEMA's costs for monitoring evacuation plans, and things of that nature. We think this is a further extension of the President's various proposals for user fees, so that, rather than the burden of administrative costs being borne by all taxpayers, they more properly be borne by the people who benefit directly from the actions of the agency involved. We urge consideration of those two user fees.

Mr. Chairman, that concludes my prepared remarks on the budget proposals, and I would be happy to answer any questions.

[The prepared statement of Mr. Chapoton follows:]

Release Upon Delivery
Expected at 2:00 p.m., E.S.T.
March 16, 1988

STATEMENT OF
O. DONALDSON CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

It is a pleasure to be here today. I am pleased to have this opportunity to present the views of the Treasury Department regarding certain budget receipts measures included in the President's fiscal year 1989 Budget proposal.

The budget does not contain any major new revenue proposals. We believe that it would be counterproductive to adopt any major new tax measures at this time. It is essential that we continue to maintain low rates of taxation for both corporations and individuals. Moreover, having just achieved a sweeping reform of our tax structure, we must give the system a rest and provide a more stable environment for taxpayers in which to make their economic and business decisions. No ingredients are more important to sustained economic growth than low tax rates, coupled with the promise of certainty.

With these broad policy objectives in mind, the President has made receipts proposals in his Budget for Fiscal Year 1989 that would lead to neither a significant revenue loss nor a general tax increase for the American taxpayer. Rather, the proposals are intended primarily to promote further sustained economic and social progress, to eliminate certain relatively minor legal or structural problems with current law, and to impose reasonable user fees and related measures with respect to Federal programs that deliver services to identifiable beneficiaries.

We also support prompt passage of legislation making technical corrections to the Tax Reform Act of 1986 and to the Omnibus Budget Reconciliation Act of 1987. It is imperative that technical corrections legislation be adopted by Congress as soon as possible to alleviate taxpayer uncertainty and to ensure that the intent of Congress in enacting the 1986 and 1987 tax legislation is carried out. Many technical amendments are essential for the proper interpretation and administration of the provisions that they affect, and therefore are important to the full implementation of tax reform. In addition, we support extension of the tax refund offset program through June 30, 1990.

I will first discuss the Administration's proposals that we estimate will have a negative revenue impact in fiscal year 1989. Then I will describe certain proposals designed to correct technical flaws in current law in order to comply with GATT. Finally, I will summarize the revenue raising proposals estimated to have an effect in fiscal year 1989.

College Savings Bonds

Background

Providing for the costs of higher education has traditionally been the responsibility of the student and his family. Unfortunately, the costs of a college education have been rising twice as fast as other prices in the economy over the last decade. Private education costs are up almost 90 percent

since 1980, and public education costs have risen more than 70 percent during the same period. It now costs an average of more than $50,000 for a family to send a child to a four-year private university and more than $18,000 to send a child to a public university. The Education Department estimates that, nineteen years from now (in 2007), the total cost of attendance will increase to $200,000 for a private university and $60,000 for a public university.

Even though scholarship and loan programs are available, substantial evidence exists that many families are not saving enough to meet these costs, especially for more expensive schools. A 1984 Roper Poll 1/ showed that only half of the families who expect their children to attend college save anything at all for their children's future college education and that among the families that do save, the median saving is approximately $500 per year. As a result of the lack of planned saving, some students are limited in their choice of colleges. In addition, the lack of savings puts considerable pressure on family finances and raises the cost of Federal student aid. These problems are especially significant for students from moderate income families, since most financial aid programs assume that these families will pay a substantial portion of education costs.

Proposal

Under the Administration's College Savings Bond proposal, interest on College Savings Bonds would not be taxed currently and would be exempt from taxation when received if the bond proceeds are used to pay for the costs of a post-secondary education. If the bond proceeds are not used for this purpose, the deferred interest would be taxable upon redemption.

The types of educational costs qualifying for the tax exemption would include tuition, books, appropriate room and board charges, and other fees associated with full-time and part-time attendance at eligible institutions that meet the standards for participation in the Education Department's student aid programs.

In order to target the program to low and moderate income families, the exemption from tax on interest income would phase out at annual levels of gross income between $60,000 and $80,000, adjusted for inflation after 1989. Thus, taxpayers whose adjusted gross income exceed $80,000 (adjusted for inflation) at the time the bonds are redeemed would not benefit from the exclusion. The income phase-out would be determined by the parents' income if the student has been claimed as a dependent by the parents in any of the three previous years; otherwise, the income phase-out would be determined by the student's income. Thus, if a grandparent buys a bond in the name of a grandchild, the income phase-out would be based on either the child's or the parents' income.

Discussion

Although the Administration believes that the primary responsibility for financing the costs of post-secondary education should remain with the student and his family, a Federal program to encourage saving for college education would not only call the attention of families to the need for saving, but would also provide a convenient mechanism and incentive for them to do so. We believe that College Savings Bonds would provide valuable and urgently needed assistance to American

1/ "A National Study on Parental Savings for children's Higher Education Expenses," conducted for the National Institute of Independent Colleges and Universities by the Roper Organization, August 1984.

families in financing post-secondary education. There is a growing awareness of the need for such a program, as evidenced by the number of bills for Federal educational savings programs introduced in the 100th Congress.2/

The benefits of College Savings Bonds can be illustrated by the following example. If a parent of a two-year old child purchases $2,000 in bonds in 1988 and in each succeeding year, the total accumulated funds would exceed $60,000 by the time the child is 18 (assuming an interest rate of 7.2 percent). This would be enough to pay the expected future costs of sending the child to a public university for four years. The tax savings for a family in the 15 percent bracket would be $4,400, or 7 percent of the total cost.

Revenue Impact

Based on the Education Department's estimate of participation, sales of College Savings Bonds would initially be $4-5 billion annually. The net cost of the program would be $10 million in fiscal year 1989, rising to $200 million in the fifth year of the program. There would also be administrative costs depending on the method of implementing the program.

Research and Experimentation (R&E) Credit

Background

Under section 41 of the Internal Revenue Code of 1986 (the "Code"), a 20 percent tax credit (the "R&E credit") is allowed for a certain portion of a taxpayer's "qualified research expenses." This credit is scheduled to expire on December 31, 1988. The portion of a taxpayer's qualified research expenses that are eligible for the credit is limited to the lesser of (1) the excess of such expenses in the current year over the average amount of such expenses for the prior three-year period (the "base amount"), or (2) 50 percent of qualified research expenses in the current year. Current law provides that the R&E credit is only available in connection with qualifying amounts paid or incurred in carrying on any trade or business of the taxpayer.

Proposal

The Administration proposes to establish a permanent R&E tax credit.

Discussion

If the credit is to have the intended incentive effect, taxpayers must be able to plan their research activity with certainty that the credit will be available. Thus, enactment of a permanent R&E credit is a high priority of this Administration.

We understand that many have suggested that it would be appropriate to analyze alternative ways of structuring the credit to increase its incentive effect in relation to revenue cost. We are receptive to proposals that would make the credit even more efficient as an incentive for research and experimentation. In this regard, we have studied possible improvements to the credit, and would be pleased to work toward this end with this Committee and other interested parties.

2/ A number of bills introduced in the 100th Congress would provide tax incentives to save for higher education by creating either Education Savings Bonds (S. 1662 and S. 1817), Education Savings Accounts (S. 1533, S. 1659 and S. 1660 and S. 1661), or Education Savings Trusts (S. 1572). These bills would provide either deferral of, or exclusion from, tax with respect to income which is used to finance qualified educational expenditures.

Let me emphasize that our highest priority remains the enactment of a permanent credit for research and experimentation. We will not support any changes to the current credit that would impede that goal.

Revenue Impact

We estimate enactment of a permanent R&E credit would reduce revenue in fiscal year 1989 by $0.4 billion.

Apportionment of Research and Experimentation Expenses

Background

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation, and for other tax purposes, sections 861-863 of the Code require taxpayers to apportion expenses between foreign source income and U.S. source income. A shift in the apportionment of expenses from U.S. to foreign source gross income decreases foreign source taxable income. This decrease may reduce the foreign tax credits that may be taken, thus increasing U.S. tax liabililty. Treasury Regulation section 861-8 allows corporations with foreign operations to allocate at least 30 percent of total research and experimentation expenditures ("R&E expenses") to their domestic operations. Initially promulgated in 1977, section 861-8 of the Regulations actually came into effect for the first time in August 1987 after the effective date of the regulation was pushed back by Congress on several occasions. Pursuant to a provision of the Tax Reform Act of 1986, corporations were allowed to allocate 50 percent of R&E expenditures to current income for taxable years beginning after August 1, 1986 and on or before August 1, 1987.

Proposal

The Administration proposes that U.S. taxpayers be permitted to apportion at least 67 percent of R&E expenses incurred within the United States to U.S. source income for taxable years beginning after August 1, 1987. Taxpayers would be permitted to allocate the remaining R&E expenses according to either the ratio of foreign to worldwide sales or the ratio of foreign to worldwide gross income.

Discussion

Because the applicable rules relating to the allocation of R&E expenses have been uncertain, an unstable tax environment has been provided for firms attempting to plan their expenditures. A statutory solution would provide much needed permanence. The Administration supports the 67 percent allocation proposal because it would create a significant incentive for firms to increase their overall R&E expenditures.

Revenue Impact

We estimate that enactment of this proposal would reduce revenue in fiscal year 1989 by $0.4 billion.

Exemption of Mutual Fund Shareholders
From Two-Percent Floor

Background

Section 67 of the Code, as enacted by the Tax Reform Act of 1986, imposes a floor on the deduction of miscellaneous itemized deductions (such as investment expenses and employee business expenses that are not deductible in calculating adjusted gross income). Subject to certain exceptions, individuals and taxpayers taxed like individuals may deduct miscellaneous itemized deductions only to the extent that the aggregate amount of the deductions exceeds two percent of the taxpayer's adjusted

gross income. Under the rules that generally apply for taxing mutual funds and their shareholders, mutual fund expenses are not passed through to shareholders, and hence are not subject to the two-percent floor on miscellaneous itemized deductions. However, Code section 67(c) directs the Treasury Department to prescribe regulations to prevent the indirect deduction of mutual fund expenses (and those of other passthrough entities) in cases in which the expenses would not be deductible if incurred by an individual. The Omnibus Budget Reconciliation Act of 1987 delayed for one year, until January 1, 1988, the application of this rule to expenses of publicly traded mutual funds.

Proposal

The Administration proposes to exempt permanently the expenses of publicly traded mutual funds from the two-percent floor on itemized deductions.

Discussion

The Administration believes that requiring shareholders of mutual funds to pass through expenses to shareholders would create complexity and confusion and place mutual funds at a competitive disadvantage compared to other financial institutions such as banks and brokerage firms, the expenses of which are not subject to the two-percent floor. Investment in publicly offered mutual funds offers shareholders significant advantages -- access to professional investment management at reasonable cost, investment diversification, and liquidity -- wholly unrelated to inapplicability of the two-percent floor. Accordingly, we do not believe that investment in a publicly offered mutual fund should be viewed as an avoidance of the two-percent floor.

Revenue Impact

We estimate that enactment of this proposal would reduce revenue for fiscal year 1989 by $0.4 billion.

Repeal of the Windfall Profit Tax

Background

Under current law, the windfall profit excise tax is imposed on domestically produced crude oil. Taxable crude oil is classified in three tiers. Generally, oil in tier one is "old" oil that had been subject to price controls; oil in tier two consists of oil produced by a stripper well, plus petroleum reserve oil; and oil in tier three is newly discovered oil, tertiary oil, and heavy oil. The tax base is the difference between an inflation adjusted statutory base price and the amount for which oil is sold, less a severance tax adjustment. The tax rate is 70 percent for tier one oil, 60 percent for tier two oil, and 30 percent for tertiary oil and heavy oil. The tax rate for newly discovered oil is 22-1/2 percent through 1987, 20 percent for 1988, and 15 percent for 1989 and thereafter. Independent oil producers are taxed at a 50 percent rate for tier one oil with respect to 1,000 barrels per day of production and are exempt from the windfall profit tax on stripper well oil.

The windfall profit tax is scheduled to phase out over a 33-month period beginning in January 1991, or the first month after December 1987 in which cumulative net receipts exceed $227.3 billion, whichever date occurs first.

Proposal

The Administration proposes to repeal the windfall profit tax.

Discussion

The windfall profit tax was enacted in 1980 when a dramatic increase in the price of domestic crude oil was expected due to the decontrol of prices. Although the price of domestic oil did initially reach record highs, the price of oil has dropped so much that it is now generally below its pre-decontrol level (when adjusted for inflation). Consequently, little or no windfall profit tax is being collected. Moreover, the tax itself is no longer appropriate. Even if crude oil prices again rise to levels that would generate significant profits for domestic oil producers, such profits should not be considered "windfall" profits. A return to a profitable situation for domestic oil producers would be the result solely of market conditions and not the result of the government lifting an artificial price barrier, as was the case when the tax was first imposed. Finally, the tax is quite complicated. Thus, given that it raises little or no revenue, it imposes an unnecessary burden on the U.S. oil industry.

In general, the Tax Reform Act of 1986 was designed to produce uniform rates of taxation on the income generated in different activities, and to eliminate tax-induced distortions in investment. Repeal of the windfall profit tax is consistent with that objective. Despite the fact that little or no windfall profit tax is currently being collected, the potential future imposition of the windfall profit tax constitutes a disincentive for domestic oil and gas exploration and development relative to other activities at a time when our reliance on unstable sources of supply is increasing.

Revenue Impact

Under current oil price projections, we estimate that the repeal of the Windfall Profit Tax would not have any revenue impact in fiscal year 1989.

Changes in Oil and Gas Depletion Rules

Background

Under current law, independent oil producers are limited in their use of depletion deductions by two provisions. First, under Code section 613A(c)(9), percentage depletion is unavailable for oil and gas properties that have been transferred after they have been "proven.". A property is "proven" if at the time of the transfer the "principal value" of the property has been demonstrated by prospecting or exploration or discovery work.

Second, under Code section 613(a), depletion deductions may not exceed 50 percent of the owner's net income from the property. In cases in which percentage depletion exceeds 50 percent of the net income from property, producers must deduct the lesser amount of 50 percent of net income (or use cost depletion, if the resulting deduction is greater than the allowable percentage depletion.)

Proposal

The Administration proposes to remove the transfer restriction on proven properties and to raise the deduction limit to 100 percent of the property's net income, effective January 1, 1989.

Discussion

The transfer rule's restriction on percentage depletion discourages the transfer of wells that are uneconomic in the hands of current owners to owners that are more efficient, more willing to bear current losses, or better able to use the tax benefits of current depletion. By repealing the transfer rule,

for example, small producers could use percentage depletion on properties they bought from integrated oil companies. Thus, small producers with lower overhead would be encouraged to buy such properties and to continue to operate them. By keeping marginal wells in production, U.S. oil production would be maintained without additional drilling costs.

At current oil and gas prices, the 50 percent net income limitation may significantly reduce the benefits of percentage depletion for production from properties generating a small amount of net income. Raising the net income limitation to 100 percent of net income would allow some oil producers to claim greater depletion deductions, thus encouraging them to operate marginal properties. Moreover, raising the limit might also encourage added investment in new oil projects.

Revenue Impact

We estimate that enactment of these proposals would reduce revenue in fiscal year 1989 by $52 million.

Branch Tax Credit

Background

The Tax Reform Act of 1986 imposed a tax on the U.S. branches of foreign corporations doing business in the United States. This "branch tax" is equal to 30 percent (or the lower treaty rate) of a corporation's "dividend equivalent amount." The "dividend equivalent amount" is the earnings and profits of a U.S. branch of a foreign corporation attributable to income effectively connected (or treated as effectively connected) with a U.S. trade or business, subject to certain adjustments.

Proposal

The Administration proposes to provide a tax credit to U.S. shareholders for branch taxes paid by their foreign corporations. A credit also would be provided to U.S. shareholders of foreign corporations for withholding taxes on dividends paid by their U.S. subsidiaries.

Discussion

The branch profits tax was viewed by Congress as an appropriate substitute for the shareholder-level tax that applies to U.S. subsidiaries of foreign corporations. If a foreign corporation subject to the branch profits tax has U.S. shareholders, however, they suffer an unintended additional level of taxation. The proposed branch tax credit would eliminate this double taxation of U.S. shareholders by allowing them to credit the branch tax paid by the foreign corporation against their tax liability on the dividends paid by the corporation.

Revenue Impact

We estimate that enactment of this proposal will decrease revenue in fiscal year 1989 by $30 million.

Revise Customs Users Fees

Background

In 1986, Congress enacted ad valorem users fees on imports. The rate of the fees is 0.22 percent of value in 1987, dropping to 0.17 percent in 1988. The reason for enacting these fees was to ensure that the costs of services provided by the U.S. Customs Service are borne by the users of those services and not by the general taxpayer. Accordingly, the proceeds of the fees are deposited in a dedicated Customs Service account and are used exclusively for the funding of Customs costs in processing all commercial imports. The fees were scheduled to expire on

September 30, 1989. Under the Omnibus Budget Reconciliation Act of 1987, the ad valorem fee was extended through September 30, 1990.

Under a ruling pursuant to the General Agreement on Tariffs and Trade ("GATT"), however, it was held that the fees violate the principles of GATT. It was found that because the customs fees are ad valorem such fees do not reflect the cost of processing individual entries.

Proposal

The Administration will propose specific legislation that will ensure that the customs user fees are consistent with GATT. In addition, we propose that, upon collection, such fees be classified as budget receipts.

Discussion

The imposition of user fees with respect to imports is consistent with the concept that those who benefit from specialized government services should pay for them directly. To ensure that the fees do not violate GATT, however, modifications to the current structure of the fees must be made. Moreover, the Administration believes that it is most appropriate to treat such fees as budgetary receipts.

Revenue Impact

We estimate that enactment of the proposal making customs user fees GATT neutral would increase the net deficit by $0.1 billion in fiscal year 1989. Switching the method of budgetary accounting for all customs user fees would have no impact on the deficit.

Modification of
Superfund Petroleum Tax

Discussion

The tax rate of the Superfund petroleum tax currently imposed on domestic crude oil is 8.2 cents per barrel and on imported crude oil and petroleum products is 11.7 cents per barrel. This tax differential, if not modified, could subject the United States to retaliation or possible compensatory damage payments under GATT. The Canadian Free Trade Agreement requires the United States to eliminate the Superfund tax differential. If the differential is still in effect on January 1, 1989, the United States may lose Free Trade concessions offered by Canada.

Proposal

The Administration proposed to eliminate the Superfund petroleum tax differential by equalizing the tax rate on domestic and imported petroleum at 9.65 cents per barrel.

Discussion

The proposed 9.65 cents per barrel rate would represent only a slight increase in the excise tax on domestic crude oil and would make the tax consistent with GATT.

Revenue Impact

The Administration expects that enactment of this proposal would have no impact on revenues in fiscal year 1989.

Extend Medicare Hospital Insurance Coverage to all State and Local Government Employees

Background

State and local government employees who began work after March 31, 1986 are covered by Medicare Hospital Insurance, and a tax is imposed on both the employee and the employer to pay for this benefit. The rate of tax for 1988 is 2.9 percent of the employee's wages (up to $45,000), paid half by the employer and half by the employee. An employment tax for Medicare is not imposed, however, on the wages of State and local government employees who were hired before April 1, 1986. Nonetheless, roughly 75 percent of such employees receive valuable Medicare coverage without paying their fair share because of eligibility through a spouse or because of a prior period of work in covered employment. Medicare coverage is mandatory for Federal employees, regardless of when hired.

Proposal

The Administration proposes to extend Medicare coverage to State and local government workers hired before April 1, 1986, effective January 1, 1989.

Discussion

Extension of Medicare coverage to State and local government employees hired before April 1, 1986, who are the only major group of employees in the United States not participating fully in Medicare, would ensure that they all receive hospital, physician and related Medicare protection. Such a change also would eliminate the charge to the Medicare trust fund caused by the fact that 75 percent of uncovered State and local employees receive Medicare coverage because of prior work in covered employment or because of coverage through a spouse, even though they are not subject to the payroll tax.

Revenue Impact

We estimate that this change in Medicare coverage will increase revenue by $1.6 billion in fiscal year 1989.

Nuclear Regulatory Commission User Fees

Background

The Nuclear Regulatory Commission ("NRC") currently recovers 45 percent of the cost of regulating nuclear power plants through user fees. The Comprehensive Budget Reconciliation Act in 1983 initially set the fees at 33 percent of expenses, and the Omnibus Budget Reconciliation Act of 1987 raised the fees from 33 to 45 percent of expenses.

Proposal

The Administration proposes to increase NRC user fees to a level sufficient to recover 55 percent of NRC's costs, effective October 1, 1988.

Discussion

The Administration's proposal is consistent with its belief that direct beneficiaries of services should pay for such services, rather than all taxpayers.

Revenue Impact

The Administration estimates that this proposal will increase revenues by $45 million in fiscal year 1989.

Federal Emergency Management User Fees

Discussion

Currently, none of the costs of the Federal Emergency Management Administration ("FEMA") in acting as the NRC's agent in monitoring evacuation plans relating to nuclear power plants are recovered.

Proposal

The Administration proposes that user fees be implemented, effective October 1, 1988, to recover 55 percent of FEMA's costs in monitoring evacuation plans.

Discussion

The Administration's proposal is consistent with its belief that the direct beneficiaries of services should pay for such services, rather than all taxpayers.

Revenue Impact

We estimate that this proposal will increase revenues by $4 million in fiscal year 1989.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary. Mr. Duncan?

Mr. DUNCAN. Thank you, Mr. Chairman. Mr. Secretary, a lot of discussion and confusion seem to exist about the relationship of trust fund surpluses to the Federal deficit, deficit financing, and the future of taxes that are earmarked to those funds. Can you explain to us just exactly how the trust funds operate within the Federal budget, and the ramifications of the earmarked taxes, and the surpluses building?

Mr. CHAPOTON. Yes.

It is a unified budget, and the trust funds as they now exist count toward the total budget deficit or budget surplus the years that we have that. The moneys that come from those sources that go into the trust funds are expended for highways, Social Security benefits, or whatever the authorized expenditures are.

We would support continuation of the unified budget method of calculating the deficit.

Mr. DUNCAN. According to some of the budget documents, there seems to be a problem with the current Customs fees and the GATT. Do you have a proposal or solution as to how this might be corrected? Or are you familiar with that?

Mr. CHAPOTON. The Customs, did you say?

Mr. DUNCAN. Yes. Some of the documents indicate that there is a problem with current Customs fees and GATT, and I was just wondering if you are familiar with the problem.

Mr. CHAPOTON. Yes, but I did not realize, if it's the case, that that gets into the trust fund issue. But the problem there is that the concept put into the 1986 act was to charge a user fee for processing activities of the Customs Service related to importing goods. It was an ad valorem fee based on the valuation of the imported goods.

Under the GATT rules, it has been determined that that is not a proper measurement to determine a user fee because it does not properly reflect what the actual cost to the Customs Service to handle and process those goods; it really reflects the value of the goods coming in, which may bear no relationship to the cost to the Customs Service. Therefore, it is an import duty and should be changed so as not to violate the GATT principles. To be a true user fee it must relate to the actual cost involved. Our purpose was not to impose an import duty.

Mr. DUNCAN. Do you have any particular solution as to how we do it?

Mr. CHAPOTON. A solution is being worked on.

Mr. DUNCAN. Thank you very much, I compliment you upon your statement.

Chairman ROSTENKOWSKI. Mr. Pease?

Mr. PEASE. Thank you very much, Mr. Chairman. Mr. Chapoton, we are delighted to have you here, as usual. Just looking through your testimony I must say I'm a little surprised to see your proposal for college savings bonds. You say that a Roper poll shows that only half of the families who expect their children to attend college save anything at all for that education, and of those who do, the median savings is $500 per year. That's pretty anemic, isn't it?

Mr. CHAPOTON. Yes, sir, it is. We agree.

Mr. PEASE. I'm surprised—the poll was taken in 1984, 3 years after the 1981 Tax Act was supposed to have unleashed a huge degree of private savings. Did something go wrong? Did that private savings not occur?

Mr. CHAPOTON. We're not sure of the exact cause. It hasn't worked well enough because the figures indicate that savings earmarked for college are not being accomplished. Incidentally, the poll merely related to how much money was being put aside for college expenses. It doesn't indicate whether or not they are saving for other purposes.

Mr. PEASE. I see.

Mr. CHAPOTON. And we think it's important. We know that a major impact of our proposal for college bonds will be to shift some savings from other savings instruments such as stocks and bonds, into the college savings bonds. There will be some shifting of savings. We hope there will be some increase in savings as well, but we know there will be a significant shifting of savings, and we think that's a very positive effect. It would show that people had become aware of the need to put aside money for future education expenses.

Mr. PEASE. I'm glad that you mentioned that because it seems to me we have the same situation here, at least the potential for the same situation, as we have had with IRA's. High income people were saving money every year anyhow; they just shifted $2,000 a year out of whatever account they had it in and put it into an IRA. There wasn't any net increase in saving—or very little—for those families.

You at least have an income cap here, but you're telling me upfront that you expect that there would be very significant shifting from one savings instrument to another, and you hope that there might be some increased savings as well. Is that right?

Mr. CHAPOTON. Yes, that's correct, Mr. Pease. I think that there will be some increased savings. We feel certain of that, and I don't want to belittle that or deemphasize it. We think that's a positive trend. But the shifting is a very positive thing. And I want to emphasize some other aspects of it, too. The savings bond is an easy way for a small taxpayer to put aside money. It would be very similar to series E savings bonds and its a very safe investment.

We think there are many benefits and we hope that it also will increase savings.

Mr. PEASE. It certainly does have a lot of things to be said for it, I will grant you that.

Say this becomes effective and a family has a couple of kids around 9 or 10 years of age. They save for 10 years at $2,000 a year, and if their income is $75,000 and they spent $15,000 for tuition to send the child off to college and also buy a $25,000 BMW in the same year—do they get to take that $15,000 out of the bank tax free?

Mr. CHAPOTON. If they made $75,000 that year, they would be limited on the amount of the $15,000 they could get tax free, because our proposal phases out between $60,000 and $80,000. Three-quarters of the interest would be taxable and only one quarter of it would be tax free.

Mr. PEASE. Let's drop it back down to $60,000. If you make $60,000?

Mr. CHAPOTON. If they used these funds for educational purposes—books, tuition, reasonable living costs—they would be exempt from tax on those funds.

Mr. PEASE. What you are saying is these moneys are *fungible*, whatever they use for education, they can use their other savings, cash, for a BMW or a boat or motor home, whatever they want; is that right?

Mr. CHAPOTON. That's correct. Money is fungible so there would be no way to limit that sort of purchase.

Mr. PEASE. Mr. Chapoton, a couple of years ago the Treasury joined Congress in advocating a tax reform act, which I thought tried to cut down on opportunities like that for people to move their revenue or their income around in a way that reduced their taxes. I am surprised and sorry to see you backsliding.

Let me turn to one other issue, on the same matter, and that is you say that you would anticipate initial savings annually of $4 to $5 billion, the net cost would be $10 million in fiscal year 1989, which makes it seem like a very inexpensive program, rising to $200 million in the fifth year of the program. It seems to me in the out years, 10, 15 years out, if we are putting $4 to $5 billion in a year, somebody is going to be taking $4 or $5 billion out a year. If that is the case, marginal tax rates of 15 to 28 percent, we are looking at a revenue loss of $1 billion a year.

Does that add up to you?

Mr. CHAPOTON. That is correct. Our revenue estimate is $10 million loss for the first year, it grows to about $200 million in 5 years, and it continues to grow after the fifth year. We anticipate that the growth will stop, but that growth will exceed $200 million. We estimate that in 12 to 17 years, it will grow to as much as $900 million, close to $1 billion, and then level off. There is growth out there.

Mr. PEASE. Then we have a revenue loss of $1 billion a year in perpetuity.

Mr. CHAPOTON. It will continue after that. When you present value that revenue loss that far off and you realize the benefit realized if it will actually encourage savings for college education and even taking into consideration, which we did, the suggestions you made about changing the concept, we are trying not to change the concept of the 1986 act, we think this is a worthwhile proposal to consider.

Mr. PEASE. Mr. Chapoton, I hope you will take another look at this proposal. Thank you.

Chairman ROSTENKOWSKI. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman. I had understood from your testimony that there was no cost of repealing the windfall profits tax, and yet page 14 of the Joint Tax Committee's study that references the Treasury Department shows a $75 million cost for repealing it over the next 5 years. Is that just a minor factor? You may not have that information.

Mr. CHAPOTON. I can clarify that. I was not aware of the Joint Tax Committee study, but there has been some uncertainty about revenue cost based upon when the estimate was made. Under the

oil and gas prices in January, February, March of this year, there is no cost in 1989.

Mr. BROWN. The report estimates that repeal of the crude oil windfall profit tax—net of income tax offsets—loses $16 million in taxes in 1989.

Mr. CHAPOTON. Let me explain. The President's budget indicates that based upon the oil and gas price assumptions existing at the time work was initially done on the budget, it indicated a revenue cost for repealing the windfall profit tax.

If you use the price forecasts that were in last fall's budget when oil and gas prices were significantly higher than they are now, there would be a revenue cost for repealing the windfall profit tax. Since then prices have dropped and, based on current oil and gas prices, we do not have a cost of repealing it. I think those are the same figures that the Joint Committee has.

Mr. BROWN. Is there a significant administrative burden for the windfall profit tax, even though it doesn't raise money, that would be relieved if we repealed it? Can we look towards a reduction in the budget of the Treasury Department or the IRS?

Mr. CHAPOTON. I'm not sure in dollars and cents—there is undoubtedly an administrative burden. The IRS has to process the forms and collect the tax. We think the greater burden is on the individual taxpayer. It is a tremendous burden to comply with the complex law and is a detriment to future oil and gas investment.

Mr. BROWN. If your folks have an opportunity to come up with some estimates of those costs, I think it would be very helpful in our deliberations here.

Mr. CHAPOTON. We may have already done some work on that.

Mr. BROWN. Both the public and private sector.

I had noted your comments about the education bond. Have you calculated into your figures the savings that would result in the educational assistance programs as a result of the utilization of this savings alternative?

Mr. CHAPOTON. Our estimates attempted to take that into account but I'm not sure that there would be any direct impact on that. Excuse me.

[Conferring off the record.]

Mr. CHAPOTON. I'm not sure how explicitly it was considered but there is nothing in there that covers that fact.

Mr. BROWN. I would hope if your folks have a chance, they might look at that. I am somewhat familiar with those programs. Basically what we have now is an enormous level of public assistance for students who are in need and go to college. If they have more resources they get less financial aid. If they don't have the resources, they get more. My guess is you are looking at an enormous offset here.

Mr. CHAPOTON. Our hope is that this will encourage people who might not otherwise be able to go to college. Perhaps there would be a great reduction in the outlay side. You are referring to the outlay side, the cost that the Government now funds?

Mr. BROWN. Yes, a variety of loans, and the whole fabric of assistance that is available and is predicated on need. This proposal obviously dedicates resources specifically to meet that need. My guess is we will make some significant difference in that area.

Mr. CHAPOTON. I am virtually certain that our people have considered those things. It might be those savings would come into play more in the outyears than they would in the initial budget period, as the program became more mature. There is a savings here to which I'm not sure I alluded. When college or regular savings bonds are purchased, money comes into the Federal Government on which it pays a reduced rate of interest. The Treasury saves money because it has to borrow less from third parties at higher interest rates. This is a savings, which offsets to some extent the tax cost of this proposal.

Mr. BROWN. Can you tell me if your folks have identified a capital gains treatment that would both increase revenue to the Federal Government and reduce the marginal rate that capital gains are taxed at?

Mr. CHAPOTON. Mr. Brown, we are studying the capital gains proposal. As you know, the President indicated that something should be done about reestablishing the differential between capital gain and ordinary income, stating it should be a principal cornerstone of tax reform for the 1990s. We have studied a number of proposals that have come to us and will continue to do so. We have reached no definitive conclusions.

Mr. BROWN. Do you anticipate you might have some results from those studies within the next few months?

Mr. CHAPOTON. I think it might be premature to say within the next few months. We are studying data from the 1986 act changes, which caused a large realization of capital gains at the end of 1986.

Whether any of this will be released in the form of a study in the near future, I'm not sure at this time.

Mr. BROWN. Thank you. I yield back, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

On the administration's proposal regarding education, this phase out is between $60,000 and $80,000 a year. You are talking about tuition, room and board for 4 years, perhaps costing as much as $200,000 19 years hence. I am wondering, for example, in my position, making $89,500 as a Congressman, I would be ineligible; right?

Mr. CHAPOTON. That's correct.

Mr. CRANE. With eight kids.

Mr. CHAPOTON. You present a sympathetic case. I understand your point. It is simply consideration of cost containment on the program.

Mr. CRANE. My education costs, I couldn't even do it for one of my eight children. I wouldn't qualify.

Mr. CHAPOTON. That's correct.

Mr. CRANE. I would be facing $1.6 million in education costs in 19 years, if presumably all eight kids went to college. It would seem to me that some kind of an adjustment based on kids would be dictated.

Let me ask another question. Since my wife and I each can give $10,000 a year tax free as a gift to each of our kids, if I gave my child $5,000 in the form of a gift, could the child then, since his income is only $5,000 a year, put the $5,000 in his own name and be eligible?

Mr. CHAPOTON. He could, but the determination is made at the time the money is taken out for educational purposes. It is when the child is actually in college.

Mr. CRANE. What I mean is while I would be ineligible to get this break myself, if I gave $5,000 to the child in his name, and the child didn't make more than $1,000 a year, would the child be eligible because his income is under $60,000 a year?

Mr. CHAPOTON. No. If he was a dependent of yours any time during the preceding 3 years that the money comes out, whether he bought the bond and gets the proceeds or whether you bought it would make no difference. In other words, that is not a way around the proposal.

On the other hand, if this is a mature child who is not dependent, is out making his own money, that rule would not apply. You would look to the child's income and determine his eligibility to receive the funds tax free.

Mr. CRANE. I really think a fairer formulation, rather than one based exclusively on dollars, would be one based on how many children you had. I would hope you might give that some consideration. I mean, a minor essentially—I mean, I hope and pray none are going to college 19 years from now.

But let me ask you another question, and that has to do with the Tax Reform Act of 1986, our revenue-neutral tax reform. According to the figures I have before me, that brought in $21.5 billion in increased revenues in 1987, right?

Mr. CHAPOTON. I think that's correct; yes, sir.

Mr. CRANE. And then it loses a combined total between 1988 through 1991 of $44.7 billion. How did we miss the mark so egregiously? I mean, that's a $23.2 billion revenue loss in the 5-year period, when, by all of our calculations in putting the act together, it was revenue-neutral over 5 years.

Mr. CHAPOTON. I'm not sure that the $22 or $21 billion, whatever it is, sounds like a lot of money when you realize that it's over a 5-year period. It's less than a 1-percent error, I believe.

[Mr. Chapoton conferring off the record.]

Mr. CHAPOTON. Yes, it's about one-half of 1 percent difference.

But I'm not sure to which figures you refer. If you're referring to our current budget figures, as opposed to the figures we put out some time ago, those numbers will change, and the cost of the 1986 act will actually grow if the economy does better than we estimated.

Mr. CRANE. Well, let me ask a question of our chairman.

Mr. Chairman, if our calculations at the time we were working on the 1986 bill had shown a loss of $23.2 billion instead of revenue neutrality, would the administration have signed off, given the guidelines we were working under?

Chairman ROSTENKOWSKI. I doubt very much that—the administration was the one area that insisted on neutrality, and if that were the case——

Mr. CHAPOTON. We emphasized neutrality very much. Maybe I didn't make the point very clearly.

We hope that those figures will actually show a greater shortfall than revenue neutrality for this reason. From the changes in the act the tax loss will grow if the economy does better than expected,

because rates were reduced. When rates are reduced an assumption is made about the growth in the economy. But if that assumption is low the reduced tax rates will cost you more.

I think the figure you're referring to is influenced primarily by the growth in the economy. That is a change in a basic assumption.

Mr. CRANE. Of that $21.5 billion, how much of that was capital gains taxes as a result of people cashing in October 1 to December 31 of 1986?

Mr. CHAPOTON. Mr. Crane, I don't have those figures before me.

Mr. CRANE. I heard it was the overwhelming majority, and that was projected by Treasury at the time.

Mr. CHAPOTON. I think it was the majority.

Mr. CRANE. Well, now that we're up to a 33 percent maximum capital gains tax, how does Treasury interpret that? As a revenue gainer or a revenue loser?

Mr. CHAPOTON. The increased capital gains rate, based upon the assumptions in the 1986 act and the calculations that we made at that time, show that the increase in the capital gains rate did pick up revenue.

Mr. CRANE. Well, I know. But in one of our executive sessions, they conceded to me that the overwhelming majority of their projected gain was in that 90-day window of opportunity when everybody sold off at 20 percent.

Mr. CHAPOTON. Oh, I see.

Mr. CRANE. And in that context, does Treasury have any ongoing studies or any studies being initiated of what the optimum capital gains tax would be to generate maximum revenue and simultaneously promote the biggest creation of venture capital and growth of the economy?

Mr. CHAPOTON. We are continuing to look at that, because, as Secretary Baker has said repeatedly, the failure to get a capital gains rate differential in the law was the biggest disappointment in tax reform. We are studying this question and are looking at current data I suppose everybody would like to know what the optimum rate is, but——

Mr. CRANE. But you would concede it's well below 33 percent?

Mr. CHAPOTON. I don't know that I can go that far.

Mr. CRANE. Well, wait. Let me ask you a question then, Don.

Who in the administration proposed taking it to 17.5 percent?

Mr. CHAPOTON. We did.

Mr. CRANE. Why did you do that?

Mr. CHAPOTON. Because we thought it was a good thing for the economy to do. It was not based strictly upon revenue considerations.

Mr. CRANE. Consider 15 percent, if you will. Thank you.

Mr. CHAPOTON. All right, sir.

Chairman ROSTENKOWSKI. I don't mean to blind side you, Mr. Secretary, but when Senator Bentsen and I introduced the technical corrections bill last June, Treasury issued a statement that they intended to enforce certain parts of the tax law, particularly with respect to tax exempt bonds, as if technical corrections had been enacted.

Senator Bentsen and I intend to introduce a revised technical corrections bill within a few days.

I'd like to know whether you would be willing to issue a similar statement, similar to the statement that was issued by Treasury when we originally introduced the technical corrections bill, and could you apply it more broadly to all of the noncontroversial agreed-upon provisions of the bill?

I realize that you weren't prepared for this, but I'd like you to think about that, Mr. Secretary. There is a lot of nervousness out there, and I'm sure that you want to join us in settling that.

We have not yet gotten to the fine-tuning stages of the bill, but as soon as I'm sure we're through with the conference on catastrophic health, we'll be in this room putting together a technical corrections bill.

Mr. CHAPOTON. Mr. Chairman, we'd like to do that. We support your proposition of having a bill introduced and acted on as early as possible.

And you are correct. We did issue a statement relating to tax exempt bonds was very limited. I've been told that it's been of limited benefit to those who said they absolutely needed it.

Chairman ROSTENKOWSKI. Well, I'd appreciate it, Mr. Secretary, if you'd consider it and consult with us, talk to us.

Mr. CHAPOTON. Certainly.

Chairman ROSTENKOWSKI. So that we're both running down the same track.

Mr. CHAPOTON. I'd be happy to.

Chairman ROSTENKOWSKI. Thank you very much for participating.

Mr. CHAPOTON. Thank you.

[Additional information follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

May 11, 1988

COMMITTEE ON WAYS AND MEANS
RECEIVED
MAY 16 1988

Dear Mr. Chairman:

When I testified recently before your Committee, you inquired whether Treasury would enforce the tax law in a manner that reflects the provisions of H.R. 4333 and S. 2238, two identical bills containing technical corrections to the Tax Reform Act of 1988 and the Omnibus Budget Reconciliation Act of 1987 ("OBRA"). We have given careful thought to this question.

We fully recognize that the absence of technical corrections is increasingly a source of taxpayer uncertainty and frustration. In order to assist taxpayers in understanding and complying with the Tax Reform Act and OBRA, Treasury has issued a large number of announcements, notices, rulings and regulations. Treasury cannot, however, resolve by administrative action all of the legal and practical uncertainties created by the absence of technical corrections legislation. Thus, the Internal Revenue Service is obligated to enforce the law as previously adopted by Congress, even though this may conflict with provisions in H.R. 4333 and S. 2238. Although taxpayers can of course continue to rely on our prior administrative guidance, Congressional action is required to give legal effect to the pending technical corrections legislation.

As you may know, we have concerns about several specific provisions of H.R. 4333 and S. 2238. The vast majority of the bills' provisions are noncontroversial, however, and could be acted upon promptly. We would be happy to work with Congress to produce technical corrections legislation that could be passed quickly by both Houses and signed into law by the President.

Very truly yours,

O. Donaldson Chapoton
Assistant Secretary
(Tax Policy)

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, DC 20515

Chairman ROSTENKOWSKI. I'd like to put in place before I recess because of a vote on the floor, Mr. Penner, Mr. Gramlich, and Mr. McCarthy, if you would all join us here, so that we can drop the gavel and get immediately into your participation in the panel discussion.

[Recess.]

Mr. DOWNEY [presiding]. The committee will come to order. The committee is privileged to next hear from a panel of Dr. Penner, Dr. Gramlich, and Dr. McCarthy. The committee will hear first from Mr. Penner.

STATEMENT OF RUDOLPH G. PENNER, PH.D., SENIOR FELLOW, THE URBAN INSTITUTE, AND FORMER DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. PENNER. Thank you very much. Every year of my professional career I've heard the economists say that this is a particularly difficult time to forecast, and I have no reason to question the cliche this year. There are, in my judgment, three major uncertainties and their resolution will determine the course of the economy for the next several years.

Even assuming a considerable improvement in our merchandise trade balance, the United States will probably have to borrow over $140 billion on international capital markets during 1988. Last year, private international investors were not willing to lend us nearly that much, and we borrowed massive amounts from foreign central banks who bought American assets in order to support the value of the dollar.

What will happen this year? So far things have gone smoothly, the dollar has stabilized, and with the exception of massive central bank intervention early in January, our current account deficit seems to have been largely financed by willing private investors. But it is hard to believe that so much can be borrowed without some turmoil in our future, at least of the magnitude experienced last spring and early fall when there were minor runs on the dollar. There is, of course, some risk that turmoil in foreign exchange markets will spread to domestic financial markets and then have an impact on the real economy.

It is essentially impossible to judge the magnitude of this risk. We might continue to muddle through, but there is a risk that we shall not, and it is a shame that it has to be endured.

The deficit in the current account of the United States simply reflects the fact that our spending exceeds our production. To restore balance, the rate of growth of spending will have to be held below the rate of growth of production for a considerable period of time. Budget policy could be helpful in this regard. Federal Government spending growth could be curbed directly, and tax increases could be used to curb domestic private spending.

But absent another financial crisis that results in a policy change, the dimensions of budget policy have been set through the end of fiscal 1989 by the November 1987 summit agreement between the Congress and the President. That agreement was helpful in reducing the potential growth of the deficit in fiscal 1988 and

1989, but it will only reduce the deficit absolutely if we have a better economy than most expect.

Given that budget policy is unlikely to contribute much to resolving the basic imbalance in the near future, it is necessary to turn to the private sector. Consumers did significantly curb their spending and increase their saving in the fourth quarter of 1987, so the second great uncertainty facing the economy is whether this trend will continue and if so, at what rate.

An increase in personal saving could have a highly beneficial effect in the long run by reducing our dependence on international capital markets. However, just as it is possible to shock the economy into recession by reducing the budget deficit too fast, consumers are capable of causing a recession by becoming too prudent too fast. While it seems highly probable that consumer behavior in the last quarter of 1987 will cause a slowdown in economic activity this year, it is much harder to say whether the nation will experience an outright recession. It's my current judgment that we shall escape that fate but just barely.

It was previously noted that the rate of growth of spending will somehow have to be slowed below the rate of growth of production in order to restore balance to our international accounts. It would be most pleasant if that feat could be accomplished by raising production growth rather than curbing spending growth. That raises the question as to whether production has room to grow more rapidly without accelerating inflation.

The key question is how much room for expansion is left in the economy. It's been so long since the country has experienced anything like full employment that no economist can be certain where it lies. This makes it very important to remain cautious, particularly in formulating monetary policy, since once started inflation is very painful to end, as we learned very well in the early eighties.

In summary, the economy now leaves less room for policy errors than was available in the early eighties. On the one side is the danger of inflation, on the other the danger that this very old recovery is ending. Simultaneously, the underlying structure is dependent on the continued willingness of private international lenders and foreign central banks to supply us with vast amounts of funds on reasonable terms. It's a shaky foundation on which to formulate policy.

What does this cloudy outlook imply for the budget deficit, assuming that the rest of the budget summit agreement is implemented? Obviously, a wide range of outcomes is possible, and given the uncertainties discussed above I would much prefer to avoid making a forecast. But nothing can be said about the deficit without an economic forecast, and so that unpleasant task cannot be avoided.

For this purpose, I find the CBO forecast to be quite reasonable. With regard to the uncertainties discussed above, this forecast assumes that any instability occurring in foreign exchange markets will not be sufficient to disturb the domestic economy greatly. It also assumes that consumption slows but savings rates remain below historically normal levels. Last, the assumed growth rates are below the assumed growth rate on productive capacity so that

inflation is contained. In other words, the forecast assumes that we're very lucky.

The CBO forecast implies a deficit around $160 billion in fiscal 1988 and $170 billion in 1989, but the uncertainty inherent in these estimates cannot be emphasized too much. If financial instability or weak consumer demand creates a recession in 1988 or early in 1989, the fiscal 1989 deficit could easily soar well above $200 billion. Conversely, if the expected slowdown does not materialize in 1988, the 1989 deficit could be less than $150 billion.

The Gramm-Rudman-Hollings deficit target for 1989 is $136 billion with a $10 billion margin of error that effectively raises the target to $146 billion.

It's my judgment that the odds are at least 4 to 1 against the actual 1989 Gramm-Rudman deficit being less than $146 billion even if the summit agreement is fully implemented. But the administration of Gramm-Rudman is not dependent on reality; it is instead dependent on OMB's August forecast of reality. To decide whether further deficit cuts or a sequester are likely after the August evaluation it's necessary to make a forecast of a forecast, and I find that task even more daunting than making a real forecast.

In the most likely case, uncertainty over the future course of the economy is likely to continue through August, and a forecast optimistic enough to keep the deficit below $146 billion cannot be judged to be totally unreasonable. If the economy should weaken sufficiently to rule out an optimistic forecast, it's possible that two successive quarters of less than one percent growth will have been experienced and then the Congress can turn off Gramm-Rudman.

Because Gramm-Rudman can be made non-binding by an optimistic forecast or turned off by a weak economy, the odds strongly favor the proposition that the Congress will have officially complied with GRH if it implements the rest of the budget summit deal. But the odds also strongly favor the proposition that the fiscal 1989 deficit will turn out to be larger than the $146 billion and there lies the key weakness of Gramm-Rudman.

I see that my time is up, Mr. Chairman. The last page of my testimony raises an unrelated issue of debt management. We have been spending a lot of money to lengthen the maturity of the debt. It's probably good to have lengthened the maturity, but it seems to me at this time it may be worth a second look to see if it should be lengthened further, and if it should not, it is possible to save almost a billion dollars in the net interest bill. There aren't many places you can save that amount of money.

In general terms, I think issues of debt management should be explored much more closely than they have been recently because we have one and a half trillion of privately held debt outstanding. Managing that debt efficiently as opposed to managing it inefficiently could save us a lot of money. Thank you very much.

[The prepared statement of Mr. Penner follows:]

STATEMENT OF RUDOLPH G. PENNER

Mr. Chairman, members of the Committee, I would like to thank you for this opportunity to testify.

Every year of my professional career I have heard economists say that this is a particularly difficult time to forecast. I have no reason to question the cliche this year.

There are, in my judgment, three major uncertainties, and their resolution will determine the course of the economy for the next several years.

Uncertainty Number 1

Even assuming a considerable improvement in our merchandise trade balance, the United States will probably have to borrow over $140 billion on international capital markets during 1988. Last year, private international investors were not willing to lend us nearly that much and we borrowed massive amounts from foreign central banks who bought American assets in order to support the value of the dollar.

What will happen this year? So far things have gone smoothly; the dollar has stabilized; and with the exception of massive central bank intervention early in January, our current account deficit seems to have been largely financed by willing private investors. But it is hard to believe that so much can be borrowed without some turmoil in our future, at least of the magnitude experienced last spring and in the early fall when there were minor runs on the dollar. There is, of course, some risk that turmoil in foreign exchange markets will spread to domestic financial markets and then have an impact on the real economy.

It is essentially impossible to assess the magnitude of this risk in that financial instability is often the result of purely random factors. (No one yet really understands the reasons for the October 19 crash.) Problems could be caused by an adverse aberrant swing in the trade deficit statistic, which is of dubious accuracy, or by a thousand other factors. Conversely, we might continue to muddle through. But there is a risk that we shall not, and it is a shame that it has to be endured.

Uncertainty Number 2

The deficit in the current account of the United States simply reflects the fact that our spending exceeds our production. To restore balance, the rate of growth of spending will have to be held below the rate of growth of production for a considerable period of time.

Budget policy could be helpful in this regard. Federal government spending growth could be curbed directly and tax increases could be used to curb domestic private spending. But, absent another financial crisis that results in a policy change, the dimensions of budget policy have been set through the end of fiscal 1989 by the November 1987 summit agreement between the Congress and the president. That agreement was helpful in reducing the potential growth of the deficit in fiscal 1988 and 1989, but it will only reduce the deficit absolutely if we have a better economy than most expect.

Given that budget policy is unlikely to contribute much to resolving the basic imbalance between spending and production in the near future, it is necessary to turn to the private sector. Consumers did significantly curb their spending and increase their savings in the fourth quarter of 1987. The second great uncertainty facing the economy is whether this trend will continue and if so, at what rate?

An increase in personal saving could have a highly beneficial effect in the long run by reducing our dependence on international capital markets. Indeed, consumers may be capable of making a larger contribution to correcting excessive national spending than anything that now seems politically possible in budget policy.

However, just as it is possible to shock the economy into recession by reducing the budget deficit too fast, consumers are capable of causing a recession by becoming too prudent too fast. While it seems highly probable that consumer behavior in the last quarter of 1987 will cause a slowdown in economic activity this year, it is much harder to say whether the nation will experience an outright recession. It is my current judgment that we shall escape that fate, but just barely.

Uncertainty Number 3

It was noted previously that the rate of growth of spending will somehow have to be slowed below the rate of growth of production in order to restore balance to our international accounts. It would be most pleasant if that feat could be accomplished by raising production growth rather than by curbing spending growth.

That raises the question as to whether production has room to grow more rapidly without accelerating inflation. The unemployment rate is lower than it has been in nine years and is close to the level at which many economists believe that wage increases will begin to accelerate. Average capacity

utilization is not yet at the levels usually associated with inflation, but some export industries and some industries protected against imports are going full blast. However, there is essentially no sign of wage inflation and prices are generally well behaved.

In the longer run, the rate of growth of capacity can be enhanced by encouraging saving, investment and work effort, and if our budget deficit is to be reduced, it should be done, to the extent possible, with policies that are not inimical to those activities. But in the very short run it is impossible to raise capacity significantly; so the key question is how much room for expansion is left in the economy? It has been so long since the country has experienced anything like full employment that no economist can be certain where it lies. This makes it very important to remain cautious, particularly in formulating monetary policy, since once started, inflation is very painful to end as we learned very well in the early 1980s.

The uncertainty regarding the level of full capacity will pale in importance in the short run if the current slowdown is sufficiently severe to raise unemployment significantly. But it is sure to become an issue again as the economy recovers from any slowdown that occurs.

In summary, the economy now allows less room for policy errors than was available earlier in the 1980s. On the one side is the danger of inflation; on the other, the danger that this very old recovery is ending. Simultaneously, the underlying structure is dependent on the continued willingness of private international lenders and foreign central banks to supply us with vast amounts of funds on reasonable terms. It is a shaky foundation on which to formulate policy.

The Budget Outlook

What does this cloudy outlook imply for the budget deficit assuming that the rest of the budget summit agreement is implemented? Obviously, a wide range of outcomes is possible and given the uncertainties discussed above, I would much prefer to avoid making a forecast. But nothing can be said about the deficit without an economic forecast and so, that unpleasant task cannot be avoided.

For this purpose, I find the CBO economic forecast to be quite reasonable. It implies that the economy grows slowly in 1988 at a rate slightly less than 2 percent and a recession is avoided. Growth accelerates somewhat in 1989 to a rate of 2.6 percent. The unemployment rate and interest rates rise slightly, and inflation remains below 5 percent.

With regard to the uncertainties discussed above, this forecast assumes that any instability occurring in foreign exchange markets will not be sufficient to disturb the domestic economy greatly. It also assumes that consumption slows, but saving rates remain below historically normal levels. Last, the assumed growth rates are below the assumed growth in productive capacity so that inflation is contained. In other words, the forecast assumes that we are very lucky.

The CBO forecast implies a deficit around $160 billion in fiscal 1988 and $170 billion in 1989. But the uncertainty inherent in these estimates cannot be emphasized too much. If financial instability or weak consumer demand creates a recession in 1988 or early in 1989, the fiscal 1989 deficit could easily soar well above $200 billion. Conversely, if the expected slowdown does not materialize in 1988, the 1989 deficit could be less than $150 billion.

Gramm-Rudman-Hollings (GRH)

The GRH deficit target for 1989 is $136 billion with a $10 billion margin of error that effectively raises the target to $146 billion. The deficit is measured somewhat differently for GRH purposes than is the unified deficit discussed above, but the differences are not important to this discussion.

It is my judgment that the odds are at least four to one against the actual 1989 GRH deficit being less than $146 billion even if the summit budget agreement is fully implemented. But the administration of GRH is not dependent on reality. It is instead based on OMB's August forecast of reality. To decide whether further deficit cuts or a sequester are likely after the August evaluation, it is necessary to make a forecast of a forecast and I find that task even more daunting than making a real forecast.

In the most likely case, uncertainty over the future course of the economy is likely to continue through August and a forecast optimistic enough to keep the deficit below $146 billion cannot be judged to be totally unreasonable. If the economy should weaken sufficiently to rule out an optimistic forecast, it is possible that two successive quarters of less than one percent growth will have been experienced and then the Congress can turn off GRH. GRH can also be turned off if a recession is forecast, but it is hard to imagine anyone doing that unless it appears almost certain.

Because GRH can be made non-binding by an optimistic forecast or turned off by a weak economy, the odds strongly favor the proposition that the Congress will have officially complied with GRH if it implements the rest of the budget summit deal. But the odds also strongly favor the proposition that the fiscal 1989 deficit will turn out to be larger than $146 billion and there lies the key weakness of GRH.

Debt Management

It is a far digression from the topics discussed above, but there is a largely unnoticed public policy trend that I believe deserves this Committee's attention. The Treasury has been working very hard to lengthen the average maturity of the public debt and by the end of 1987 it was 5 years and 9 months compared to a low of 2 years and 7 months at the end of fiscal 1976.

All else equal, it is probably desirable to lengthen the debt's average maturity, but all else is not equal. With long-term interest rates exceeding short rates, lengthening the maturity results in a higher interest bill than if the average maturity is held constant or allowed to shorten. I would not advocate an abrupt shortening and think that it is probably desirable to keep the average maturity above 5 years. But is is possible that a somewhat different approach to debt management that allowed a slight reduction in the average maturity could save almost a billion dollars in the net interest bill, and as this committee well knows, there are not many places in the budget where such savings come easily.

The Treasury may have good reasons for opposing this particular proposal, but more generally, with the privately-held debt now about 1 1/2 trillion, problems of debt management deserve more Congressional oversight and attention by economists than they are now receiving.

Mr. DOWNEY. Thank you very much, Dr. Penner. Dr. Gramlich?

STATEMENT OF EDWARD M. GRAMLICH, PH.D., PROFESSOR OF ECONOMIC AND PUBLIC POLICY, INSTITUTE OF PUBLIC POLICY STUDIES, UNIVERSITY OF MICHIGAN, FORMER ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. GRAMLICH. Thank you. I am just going to focus on the question of hitting the Balanced Budget Act targets and nothing else. For most of this, I'm going to draw on some new uncertainty analyses now being done at CBO, some of which was described in these reports recently put out, but some not.

In a word, as the outlook seems now, I can see a very low probability of actually hitting the Balanced Budget Reaffirmation Act target for fiscal 1989. But at the same time, I think that by August there will still be enough uncertainty in the outlook that OMB can perfectly credibly predict that we will hit the target.

As you know, CBO's best estimate of the fiscal 1989 deficit is $176 billion. Actually, now it's $177 billion. That's $41 billion above the Balanced Budget Act target. The act sequesters are limited at $36 billion. And it will be limited again to $32 billion, upon enactment of some minor measures called for in the economic summit. These amount to 9 percent sequester rates for defense and 13 for nondefense.

How likely are these forecasts to be realized? The best way to answer the question is to look at past forecasting performance, well documented in the recent CBO reports. For the 8-year period from 1980 to 1987, the first budget resolution, which generally but not always was based on the CBO forecasts, underestimated the budget deficit by an average of $42 billion, $31 billion of which was for nonpolicy reasons.

About $5 billion of this sum was attributable to the windfall profits tax on oil, which you've talked about earlier, and that now raises so little revenue that I think it can be deducted as irrelevant ancient history. When you take that out and then put it in fiscal year 1989 prices, you get an average nonpolicy error of $37 billion.

Now, in the last page of my statement I have a little picture here that makes for easy reading of what I'm about to say. There are two distributions there. One I will call a spreadout distribution and the other the compact distribution.

The spreadout distribution takes all of these errors in all years, 1980 to 1987, computes the statistical probability, and then says what is the probability that we get below the $146 billion margin of error under the Gramm-Rudman revised target. And that's 28 percent in the vertically hatched area, the spreadout distribution.

That distribution is so spread out, essentially, because very large errors were made in two years, 1982 and 1983. And there are some extenuating circumstances which I won't go into right here. But if those years were simply omitted and the whole thing recomputed, then you get a more compact distribution that leads to a probability of hitting the target in the dark shaded area. And that's 15 percent.

So, the answer to the first question of what's the probability that we will hit the target seems to be something between 15 and 28

percent, depending on how one interprets past history. This is very close to the 1 in 4 odds that you just heard from Mr. Penner, who, I think, arrived at that number independently.

Now, the second point is how will OMB call this in August? Right now the two agencies see the budget outlook differently. Whereas the CBO baseline deficit is $176 billion, the OMB deficit under the same set of assumptions is $140 billion. It's a large difference, though within the statistical range of uncertainty in the spreadout distribution described above.

Can anything be said about how OMB will see all of this in August? Not very much, I'm afraid. The CBO has done some other forecasting exercises that show how this distribution compacts as time goes on. And, basically, you get about $7 billion more precise every 3 months.

Now, projecting in December 1987, as both CBO and OMB did, the standard error by this technique is $50 billion, dropping by $7 billion every 3 months. So the standard error for fiscal 1988, which had already begun at that time, was still $23 billion.

If you move that back to say what would be the standard error, were the projections done in August, a little before the fiscal year had begun, you get roughly $30 billion. In a word, that is enough uncertainty that I think, even with the forecasting differences that are alive now, that one could credibly predict that we would hit the target in August, even if, according to the CBO estimates, there is a low probability of hitting that target.

That's it. That concludes my statement. Thank you very much.

[The prepared statement of Mr. Edward Gramlich follows:]

STATEMENT OF EDWARD M. GRAMLICH, THE UNIVERSITY OF MICHIGAN, FORMER ACTING DIRECTOR CBO

Thank you, Mr. Chairman, for asking me to testify today. My statement will cover the budget outlook and the likely uncertainty implied for the deficit estimates, much of it drawing on new uncertainty analyses now being done at CBO. In a word, as the outlook seems now, I can see a very *low* probability of actually hitting the Balanced Budget Reaffirmation Act (BBA) deficit target for FY 1989. But at the same time I think that by August there will still be enough uncertainty in the outlook that OMB can perfectly credibly predict that we will hit the target.

WILL WE HIT THE DEFICIT TARGET?

As you know, CBO's best estimate of the FY 1989 deficit is $176 billion, $40 billion above the BBA target. That Act limits the sequester to $36 billion, and it would be lowered again to $32 billion upon enactment of some minor measures called for in the Economic Summit. Were these numbers to be forecast next August, there would be sequesters of 9 percent for defense programs and 13 percent for nondefense programs.

How likely are these forecasts to be realized? The best way to answer the question is to look at past forecasting performance, well documented in the CBO reports of last August and this February. For the eight year period from 1980 to 1987, the First Budget Resolution, generally but not always based on CBO's forecasts, underestimated the budget deficit by an average of $42 billion, $31 billion of which was for non-policy reasons—either inability to forecast the economy (economic errors) or some other reason not attributable to subsequent policy changes (technical errors). About $5 billion of this sum was attibutable to the windfall profits tax on oil, a revenue source particularly difficult to forecast well but now raising very little revenue. Deducting this as irrelevant ancient history, we are left with an average past error of $26 billion, or $37 billion in FY 1989 prices.

The attached Figure shows this statistically for FY 1989. The squat distribution shows the probability of the deficit equalling various amounts using the standard error from this past performance in FY 1989 prices. The vertically hatched area is

the chance of hitting the BBA target of $146 billion (the actual target of $136 billion plus the $10 billion margin of error). It equals 28 percent.

This distribution was derived from all years in the 1980s. Inspection of the forecast errors implies that the worst mistakes were made in FY 1982 and 1983. In the first of these years, the CBO forecast was not used at all; in the second, CBO greatly overestimated GNP. Leaving these two unusual years out of the calculations, we get a more compact distribution, as can be seen. But while the distribution is more compact, since the CBO best guess is so far from the BBA target, the probability of hitting this target, shown by the shaded area, falls to only 15 percent.

There is another statistical approach. Sparing the gory details, analysts at CBO have worked out a mechanical way to replicate the near-term forecasting procedure. They can do almost as well as CBO generally does by this procedure—better in the fateful 1982 and 1983 years but worse recently—and they get a statistical distribution similar to the top line in the Figure, with a probability of not hitting the target slightly below the 28 percent mentioned above. However one does the computations, it seems reasonably likely at this point that the deficit will not hit the $146 billion target.

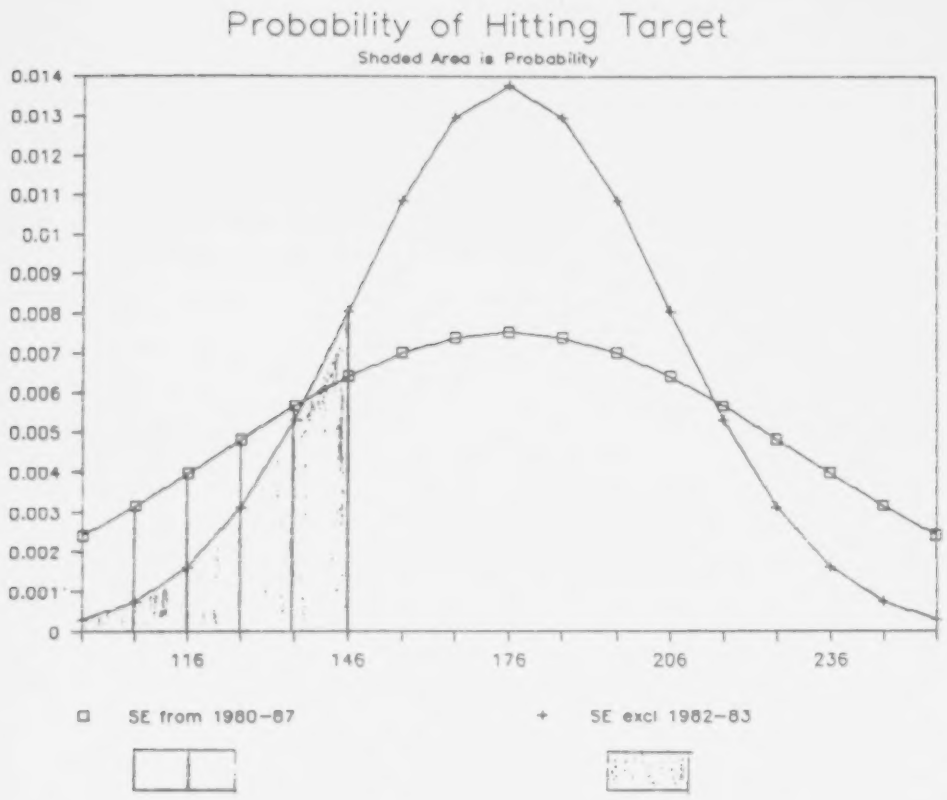
HOW WILL OMB CALL IT?

CBO does not call the sequester: that is left up to OMB. Right now the two agencies see the budget outlook differently—whereas the CBO baseline deficit is $176 billion, the OMB deficit under the same rules is $140 billion. This is a large difference, though within the statistical range of uncertainty described above. Can anything be said about how OMB will see the situation in August?

Not very much. The mechanical forecasts mentioned above indicate that one projecting in December, 1987, as both CBO and OMB did, has a standard error of about $50 billion in forecasting budget deficits for FY 1989. The standard error for FY 1988, just begun at that time, is $23 billion. Had the forecast been made three months earlier, as is required by the BBA, the standard error for FY 1988 would then have been about $30 billion, or about three-fifths of the standard errors mentioned above for FY 1989.

This means that as we go through the year, the forecasting uncertainty about the FY 1989 budget will decline, but not at a terribly rapid rate. It is still possible to make large errors, even predicting in August. Right now the CBO and OMB forecast are within a standard deviation of each other, and that could very likely still be the case in August even if neither agency has changed its view by much. This means that even though with CBO's numbers the probability of not hitting the target is high, the probability that OMB will call for a sequester in August could still be fairly low.

That concludes my statement, Mr. Chairman. Thank you very much.



Mr. DOWNEY. Thank you, Dr. Gramlich. Dr. McCarthy.

STATEMENT OF F. WARD McCARTHY, PH.D., CHIEF FINANCIAL ECONOMIST AND MANAGER OF FINANCIAL ECONOMICS, MERRILL LYNCH & CO., INC.

Mr. MCCARTHY. Thank you very much, Mr. Chairman. And I thank you for giving me the opportunity to testify. My comments will address four issues. The outlook for the economy. The outlook for the Federal budget deficit. Some comments on monetary and fiscal policy, as well as some comments on the stock market as well.

The U.S. economy should continue to grow over the balance of 1988 at a rate of about 2½ percent. Inflation, as measured by the widely followed price indices, should rise at about 4 percent.

The prospects for 1989 are less encouraging, but could improve if more significant progress is made in rectifying some of the imbalances that have characterized the U.S. economy in recent years. Specifically, recent data suggests that an important structural shift in the U.S. economy may be underway that will narrow the gap between domestic consumption and production. This is necessary to foster a greater balance between domestic savings and investment in the United States.

To date, the 1980s has been the decade of the consumer. Spending has outpaced income by a wide margin, as the savings rate has fallen to historical lows. And consumer debt-income ratios have increased to historically high levels. While consumer spending is indicative of confidence in the economy and an important facet of economic growth, the national penchant for incurring debt, as well as a strong preference for consuming imported goods, has contributed to serious imbalances that threaten the longer term economic prospects.

During this consumption splurge, demand has outpaced production in the United States and investment has exceeded savings. This behavior has contributed to the enormous international account and Federal budget deficits that now characterize this Nation.

What is necessary to correct these imbalances and improve the longer term growth prospects is a reallocation of resources from the household to the business sector or, equivalently, an increase in savings that can finance a growing share of domestic investment. As I noted a moment ago, there is evidence that this structural shift may already be underway. But what is not clear is if this change in consumer behavior is temporary or if it is indicative of a more fundamental adjustment on the part of consumer behavior.

If consumers are undergoing a temporary pause in spending that will yield to a resumption of aggressive spending activity within the next few months, then the economy will grow more rapidly in the current year but incur more significant difficulties in the years ahead. If a more fundamental and enduring change is underway that will lead to increased savings, then growth will be less robust this year and next. The pace of economic growth, however, is not the paramount issue at this juncture, but rather the transition that will bring about a narrowing of the gap between domestic consumption and production, as well as greater savings and investment.

Against the backdrop discussed above, the budget deficit for fiscal 1988 is expected to total about $164 billion, while the 1989 deficit is expected to increase to $180 billion. The widening budget deficits reflect the one-time-only nature of the sharp budget deficit reduction which occurred in fiscal 1987 as well as the slow growth environment which appears to be likely in 1988 and 1989.

On the expenditure side, 1987's growth rate of roughly one percent appears to be an exception, not the rule. Expenditure growth of about 6 percent is more likely in fiscal 1988 and 1989. It should be noted that the sensitivity of Federal expenditures to the economic environment has shifted in a pronounced fashion in recent years.

The tremendous growth in Federal debt and associated rapid increase in net interest payments has made the overall budget totals far more sensitive to the interest rate environment. For example, if net interest payments on outstanding debt were excluded, the Federal budget deficit would have been in approximate balance in fiscal 1987. Clearly, a slow growth, low interest rate environment is much more favorable for the budget deficit outcome than was the case a few years ago.

In my opinion, the Federal Reserve should continue to attempt to promote modest economic growth in a contained inflation setting. A healthy expansion of economic activity is not sustainable in an economy with excessive inflationary pressures. Given that various price indices indicate an annual inflation rate of four percent, the current inflation environment very much limits the Federal Reserve's options in implementing a more accommodative monetary policy.

Recent statements by Federal Reserve officials indicate that policymakers are focusing on market conditions as well as economic conditions in arriving at policy decisions. I think this is a useful approach to monetary policy, since the markets are an important critic of policy. However, an extreme view of this approach would imply that the markets dictate monetary policy, and I do not think that would be either appropriate or workable.

In the current environment, the most appropriate approach to monetary policy appears to be one of moderation and stability for two general reasons. First, the economy appears as if it will continue to grow without significant additional monetary stimulus. Also, it does not appear as if inflationary pressures are sufficiently threatening to warrant a more restrictive posture.

This approach would also encourage stability in the domestic financial markets and international currency markets. The extreme volatility of recent years has generated uncertainties and shaken the confidence of the investing and consuming public alike. To the extent that monetary policy can instill calm and confidence into the markets, I think it is an appropriate policy.

However, the Fed is faced with a difficult environment within which to conduct monetary policy. If monetary policy becomes too tight, the risk is that the economy could slip into a recession. On the other hand, if the monetary policy should become too easy, then the risk is that the consumers would again resume their strong consumer ways and we would undo some of the progress that has been made recently toward a better balance in the economy.

Given the need to encourage savings in the United States, fiscal policy actions should also attempt to discourage consumption, to encourage savings, or both. Also, continued efforts to reduce the size of the Federal budget deficits are certainly advisable. However, it is important to acknowledge that numerical deficit reduction by itself is not enough, if it is gained simply by transferring savings from the private sector to the Government sector.

Given the need to decrease our dependence on foreign capital inflows on a national basis, not just to finance the Federal budget deficit, it is important that Congress succeed in reducing the deficits without reducing domestic savings. And certainly it is not an easy task.

Finally, given that the economy should continue to grow modestly and that the inflation environment should remain stable, the outlook for the stock market remains cautiously optimistic.

Thank you, Mr. Chairman. That concludes my testimony. I would certainly welcome any questions.

[The prepared statement of Mr. F. Ward McCarthy follows:]

Testimony by F. Ward McCarthy
Chief Financial Economist &
Manager of Financial Economics
Merrill Lynch & Co.
Before the Committee on Ways & Means

March 16, 1988

Good afternoon Mr. Chairman and members of the committee. My name is Ward McCarthy and I am the Chief Financial Economist of Merrill Lynch & Co. I would like to thank you for the opportunity to testify at these hearings.

As requested, my comments will address four issues:

What is the outlook for the economy in fiscal 1988 and 1989?

What is the outlook for the Federal budget deficit in 1988 and 1989?

What monetary and fiscal policies are appropriate?

What are the prospects for the stock market this year?

The following comments summarize my answers:

The Outlook for the Economy

The U.S. economy should continue to grow over the balance of 1988 at a rate of about 2.5%. Inflation, as measured by the widely followed price indices, should rise at about a 4% rate. The prospects for 1989 are less encouraging but could improve if more significant progress is made in rectifying some of the imbalances that have characterized the U.S. economy in recent years. Specifically, recent data suggests that an important structural shift in the U.S. economy may be underway that will narrow the gap between domestic consumption and production, and foster a greater balance between domestic savings and investment. This structural shift is necessary to improve longer-term economic growth prospects and the efficient operation of domestic financial and international currency markets. So far the improvement has been quite modest, however, and significantly more progress is necessary.

To date, the 1980's has been the decade of the consumer. Spending has outpaced income by a wide margin, as the savings rate has fallen to historically low levels and consumer debt/income ratios have increased to historically high levels. Strong consumer spending is indicative of confidence in the economy and is an important facet of economic growth. However, the national penchant for incurring debt, as well as a strong preference for consuming imported goods, has contributed to serious imbalances that threaten the longer-term economic growth prospects and the stability of the financial markets.

During this consumption splurge, demand has outpaced production in the U.S. and investment has exceeded savings. This behavior has contributed to the enormous international account and Federal budget deficits that now characterize this nation. For example, in 1982 the balance of payments moved into a deficit position of $8.7 billion --only the fifth deficit in 30 years --but the cumulative deficit since then has totaled $570 billion. That $570 billion represents the savings deficiency in the U.S., the excess of investment over savings. A favorable outlook for the U.S. requires that this savings deficiency be rectified.

What is necessary to correct these imbalances and improve the longer-term growth prospects is a reallocation of resources from the household to the business sector of, equivalently, an increase in savings that can finance a growing share of domestic investment. As I noted a moment ago, there is evidence that this structural shift may already be underway, at least at the end of 1987. Consumer spending patterns in recent months have been less robust than in recent years, and there does appear to be an increased propensity to save. It is not clear, however, if this change in consumer behavior is a temporary phenomenon triggered by a pronounced slowdown in real disposable income and enhanced by a deflating of consumer confidence in reaction to the drop in the stock market last October. Alternatively, this change could be a more fundamental adjustment that will continue in the months and years ahead even in an environment of renewed consumer confidence and somewhat stronger growth in disposable income.

If consumers are undergoing a temporary pause in spending that will yield to a resumption of aggressive spending activity within the next few months, then the economy will grow more rapidly in the current year but incur more significant difficulties in the years ahead. If a more fundamental and enduring change is underway that will lead to increased savings, then growth will be less robust both this year and next year. The pace of economic growth is not the paramount issue at this juncture, but rather the transition that will bring about both a narrowing of the gap between domestic consumption and production as well as greater savings and investment. This desired transition is the groundwork for a more prolonged period of sustainable growth without the current extreme reliance on foreign capital inflows.

The Outlook for the Budget Deficits

Against the economic backdrop discussed above, the budget deficit for fiscal 1988 is expected to total about $164 billion, while the 1989 deficit is expected to increase to about $180 billion. The widening budget deficits reflect the one-time-only nature of the sharp budget deficit reduction which occurred in fiscal 1987 as well as the slow growth environment which appears to be likely in 1988 and 1989. After growing by about 10% in fiscal 1987, personal income tax receipts will probably only grow 2% to 3% in fiscal 1988 and 1989. Similarly, the close to 30% jump in corporate income tax payments will give way to far more modest growth in fiscal 1988 and 1989.

On the expenditure side, 1987's growth rate of roughly 1% appears to be an exception, not the rule. Expenditure growth of about 6% is more likely in fiscal 1988 and 1989. It should be noted that the sensitivity of federal expenditures to the economic environment has shifted in a pronounced fashion in recent years. The tremendous growth in federal debt and the associated rapid increase in net interest payments has made the overall budget totals far more sensitive to the interest rate environment. For example, if net interest payments on outstanding debt were excluded, the Federal budget would have been in approximate balance in fiscal 1987. A slow growth/low interest rate environment is much more favorable for the budget deficit outcome than was the case a few years ago.

Fiscal and Monetary Policy

In my opinion, the Federal Reserve should continue to attempt to promote modest economic growth in a contained inflation setting. A healthy expansion of economic activity is simply not sustainable in an economy with excessive inflationary pressures. Given that the various price indices indicate an annual inflation rate of 4%, the current inflation environment very much limits the Federal Reserve's options in implementing a more accommodative monetary policy.

Recent statements by Federal Reserve officials indicate that policymakers are focusing on market conditions as well as economic conditions in arriving at policy decisions. For example, movements in commodity prices, developments in currency markets and indications of inflationary expectations, as reflected in the shape of the Treasury yield curve, all are key policy variables. I think that this is a useful approach to monetary policy since the markets are an important critic of policy. An extreme view of this approach would imply that the markets dictate monetary policy, and I do not think that would be either appropriate or workable.

In the current environment, the most appropriate approach to monetary policy appears to be one of moderation and stability for two general reasons. First, the economy appears as if it will continue to grow without significant additional monetary stimulus. As I have noted, modest growth that is characterized by slower consumer spending is desirable. At the same time, inflation pressures do not appear to be sufficiently threatening to warrant a more restrictive posture. In this environment, the Federal Reserve should attempt to contain monetary growth to the lower half of the annual target ranges and provide bank reserves with a steady hand. This approach would also encourage stability in the domestic financial markets and the international currency markets. The extreme volatility of recent years has generated uncertainties and shaken the confidence of the investing and consuming public alike. To the extent that monetary policy can instill calm and confidence into the markets, then I think that is an appropriate policy objective.

The Federal Reserve is faced with a difficult environment within which to conduct monetary policy. At the current juncture, the U.S. is in a transition from being a consumer-led to a production-led economy. This transition is evident in data that indicates that the gap between production and demand has been narrowing, although demand still exceeds production by about 3.5%. Since much of the production gain reflects rising exports, it is useful to view this economic transition in terms of the ratio of exports to consumption. Recently, this ratio has risen to 12%, after hovering under 10% for a few years.

In this context, the relative contributions of consumption and exports to economic growth create a precarious environment within which to conduct monetary policy . Specifically, with an export/consumption ratio of roughly 12%, export growth of about 8 percentage points is required to offset a reduction in consumer expenditure of about 1 percentage point. As I discussed previously, both a slowing in consumption and the increase in exports are desirable in the current setting to alleviate the imbalances of the U.S. economy. However, this trade-off should also dramatize the difficult task that the Federal Reserve will have in steering an appropriate policy path. If monetary policy is too tight, then the U.S. could slip into a recession. If policy is too easy, then it could prompt another consumer spending surge that could undo some of the progress made recently toward a better balance in the eonomy.

Given the need to encourage savings in the U.S., fiscal policy actions should also attempt to discourage consumption, to encourage savings, or both. Also, continued efforts to reduce the size of the Federal budget deficits are certainly advisable. However, it is important to acknowledge that numerical deficit reduction by itself is not enough if it is gained simply by transferring savings from the private sector to the government sector.

While the Federal budget deficit in 1987 narrowed by more than $50 billion, a substantial portion of this improvement appeared to have come at the expense of private savings and state and local government budget surpluses. Specifically, private sector savings declined by $30 billion, and state and local budget balances fell by $13 billion. As a consequence, a $25 billion widening in the current account deficit was required to finance only a modest increase in net domestic investment.

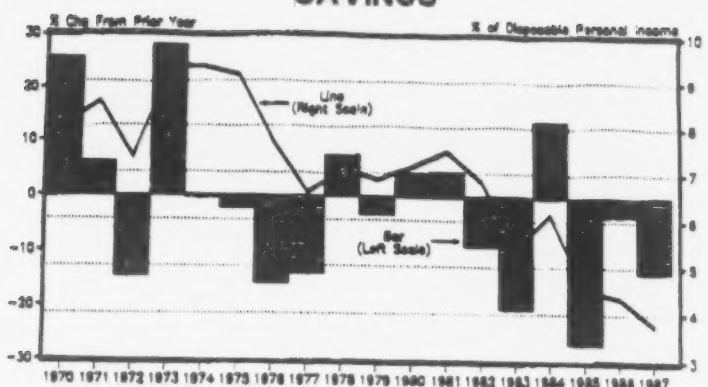
Given the need to decrease our dependence on foreign capital inflows on a national basis, not just to finance the Federal budget deficit, it is important that Congress succeed in reducing the deficits without reducing domestic savings. It is certainly not an easy task.

Outlook for the Stock Market

Given that the economy should continue to grow moderately, and that the inflation environment should remain stable, the outlook for the stock market remains cautiously optimistic. Relative performance should mirror the performance in the economy with export sector stocks being the best performers.

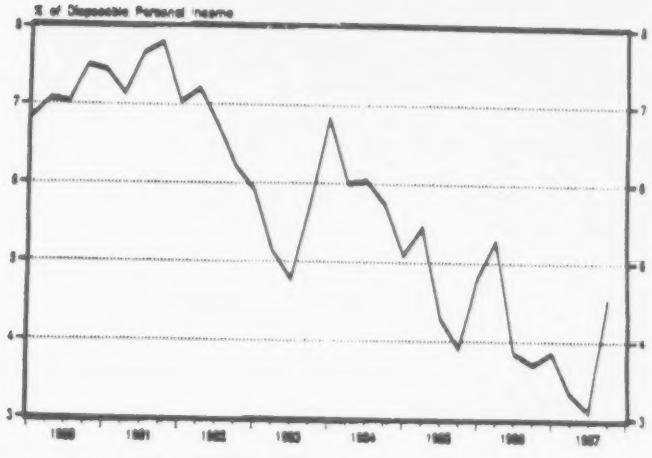
Mr. Chairman, that concludes my statement. I would be pleased to respond to any questions the Committee may have.

SAVINGS



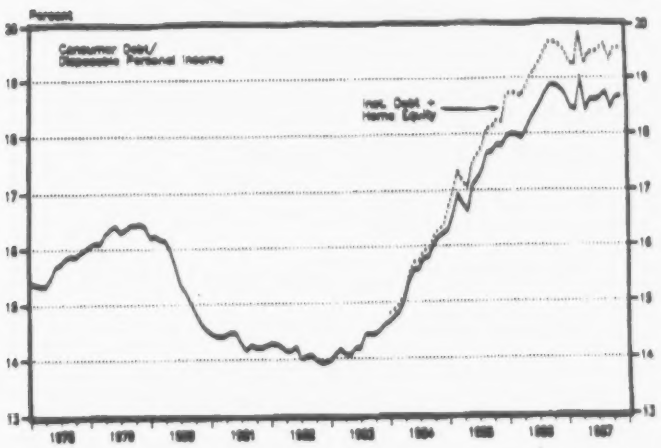
SOURCE: Department of Commerce.

SAVINGS RATE



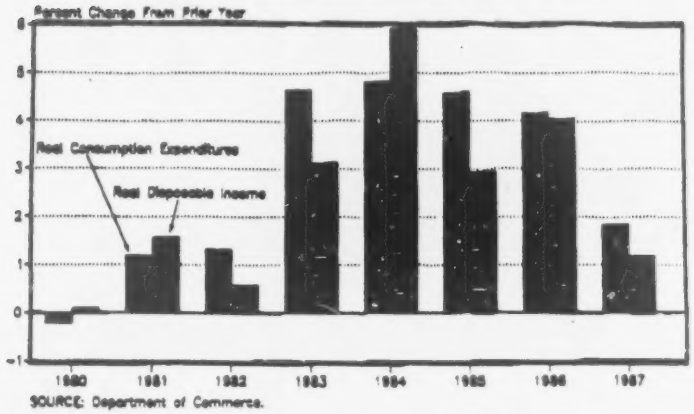
SOURCE: Department of Commerce.

CONSUMER DEBT



SOURCE: Federal Reserve Board, Merrill Lynch Economics.

SPENDING OUTPACES INCOME

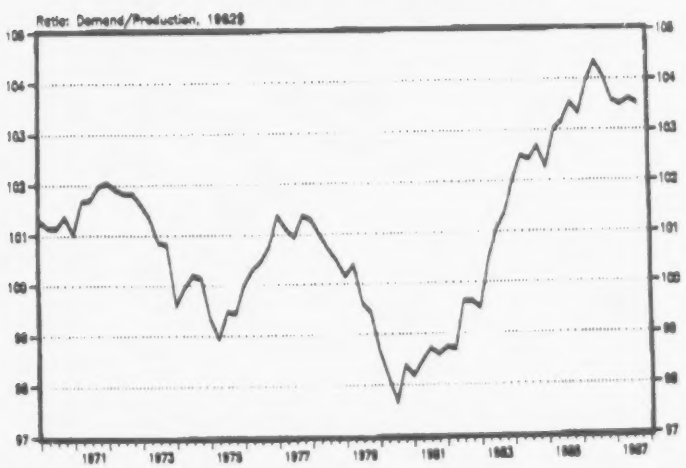


SOURCE: Department of Commerce.

MERCHANDISE EXPORTS ON THE REBOUND

SOURCE: Department of Commerce.

DEMAND AND PRODUCTION



SOURCE: Department of Commerce.

FLOW OF FUNDS APPROACH TO GNP

	1980	1981	1982	1983	1984	1985	1986	1987a	1988f
Personal Savings	137	159	134	121	154	147	131	130	172
Retained Corporate Profits*	50	56	59	48	81	45	47	26	50
State-local Budget Balance	27	29	28	67	69	82	87	84	48
Federal Budget Balance	-61	-64	-146	-176	-170	-196	-222	-181	-171
Total Net Saving	158	187	77	80	134	40	39	59	78
(% of GNP)	5.8%	6.1%	2.5%	1.6%	2.6%	0.7%	0.7%	0.9%	1.6%
Business Investment	303	349	367	329	416	442	427	441	473
Change in Inventories	-8	24	-28	-2	68	12	16	45	44
Residential Investment	123	122	108	107	181	159	219	235	232
Total Investment	438	515	447	507	665	613	671	716	750
(% of GNP)	16.0%	18.9%	14.1%	14.5%	17.5%	16.0%	15.8%	16.0%	15.8%
Corporate Depreciation	181	211	225	247	289	269	282	296	310
Depreciation Adjustments	-17	-14	-6	-5	-23	-34	-46	-48	-48
Non-corporate Depreciation	122	127	145	154	161	168	174	187	190
Total Depreciation (=)	286	324	364	396	446	491	503	527	549
(% of GNP)	10.5%	10.9%	11.8%	11.3%	11.9%	12.2%	11.9%	11.7%	11.6%
Net Domestic Investment	152	191	72	69	218	151	166	189	207
(% of GNP)	5.6%	6.9%	2.3%	2.6%	5.7%	3.8%	4.0%	4.2%	4.3%
Current-Account Balance	17	11	-1	-33	-81	-116	-161	-164	-143
(% of GNP)	0.6%	.4%	-0.0%	-1.0%	-2.4%	-2.9%	-3.9%	-3.7%	-3.0%
Total Net Investment	169	192	72	56	138	35	47	33	60
(% of GNP)	6.2%	6.3%	2.3%	1.6%	3.3%	0.9%	0.8%	0.5%	1.3%
Statistical Discrepancy	7	5	0	8	5	-5	-7	-16	-16
GNP	2732	3032	3166	3406	3772	3911	4235	4488	4745
Corporate Cash Surplus	44	-3	33	76	-4	50	47	31	30

Mr. STARK [presiding]. Thank you. I want to thank the panel. I apologize for not being here to hear your verbal testimony, but I have a couple of questions for the panel anyway, because this is a great chance to ask questions I've always wanted to ask.

First of all, Mr. McCarthy, I wonder if you have an opinion and/or empirical data on this phenomenon of single-premium life insurance, which your firm and the Pru are probably the premier marketer. Any idea or any statistics you might have to indicate whether you know how much of that is disintermediation, transfer from your cash management accounts, or out of money markets, or is it new money, new savings? Any guess or any empirical data on that?

Mr. MCCARTHY. Well, Mr. Chairman, I couldn't do anything better than guess, frankly. I have not personally conducted any investigation on that. However, I'd be very happy to prepare an answer for you and submit it to you in writing.

[The following was subsequently received:]

APRIL 4, 1988.

Hon. FORTNEY H. (PETE) STARK,
Committee on Ways and Means, 1102 Longworth House Office Building, U.S. House of Representatives, Washington, DC.

DEAR CONGRESSMAN STARK: During testimony on March 16, 1988 before the Committee on Ways and Means, you directed a question to F. Ward McCarthy, Merrill Lynch's Chief Financial Economist, concerning single premium life insurance. Merrill Lynch appreciates the opportunity to respond to the Committee regarding this subject.

First and foremost, single premium life insurance (SPLI) is an insurance contract. Like traditional permanent life insurance, SPLI provides death benefits that are significantly greater than the premium paid. Both provide important protection against the insured's premature death. Accordingly, if one accepts the fact that traditional permanent life insurance has a social value that justifies its current treatment under the tax laws, we see no reason why SPLI should be taxed any differently. In reality, SPLI is identical except for the fact that it is purchased in cash rather than on the installment plan. As is known to every consumer who has purchased an automobile, the total cost of paying cash is significantly less than the total cost of buying on the installment plan. The same is true of SPLI. For the same face amount of insurance, the total cost of any whole life policy increases as the number and duration of required premiums increases. This is a function not only of the time-value of money, but is also a function of (a) the insurance company's higher costs of administering a multi-pay policy, and (b) the sales commission structure. Single premium policies typically pay a commission of 3% to 5%, as compared to 8% or 9% on a present value basis, customarily paid on traditional permanent plans. If indeed Merrill Lynch is the largest seller of SPLI, the reason may be that many agents who have focused on traditional life insurance products have abdicated the market because of the lower commissions paid on SPLI.

In addition to the cost advantage with SPLI, the policy owner never has to worry about a policy lapse if premiums are not paid on a timely basis—the one cash payment purchases lifetime coverage.

The advertising and promotional materials of some members of the life insurance industry, both agents and insurance companies, have created many misconceptions regarding SPLI. One such misconception is that SPLI is a "yuppie" product, bought by the wealthy primarily as a form of tax shelter. In fact, over 50% of SPLI is purchased by persons over age 50 and, according to a survey by one company, the average income of insureds was only $44,000 per year.[1]

Even if SPLI is viewed solely as an investment, one should recognize that investment returns available are hindered by allowances for mortality costs and expenses. Even though some promoters omit references to mortality costs and expenses, the

[1] Statement of Robert G. Sharp, et al., on behalf of the Committee of Life Insurers before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, March 15, 1988.

INTENTIONAL BLANK

pricing of every SPLI policy contains an allowance for the costs of the insurance company's mortality risk, its administrative expenses including sales commissions, and its profits, all of which diminish the effective investment return. (In this regard, please note that Table 4 on page 19 of the "background" paper published by the Staff of the Joint Committee on Taxation on March 23 gives an illustration of two aggressively investment-oriented policies and states, "it is questionable whether such a policy would qualify as life insurance under present law if mortality charges are not reasonably related to the risk being insured." We also question whether such policies qualify; however, such abuse can be eliminated by regulation under existing IRS authority, without the need of legislation.)

Another general misconception is that there is excessive use of the loan provisions available in SPLI policies. The reality is that policy loans have only been made on 7% of SPLI policies.[2] (Policy loan provisions are required by state law.)

There is also the illusion that SPLI is sold almost exclusively by stockbrokers. In fact, our information indicates that less than 40% is sold by stockbrokers. The major reason that even this much is sold by stockbrokers is that variable SPLI, under federal law, must be sold by a person who has a securities license. Stockbrokers constitute a readily available distribution system for such a product.

In response to your specific question regarding the impact on savings, Merrill Lynch strongly believes that purchases of SPLI encourage long-term savings in the economy. As is general practice in the industry, Merrill Lynch does not collect data from policyholders regarding the source of funds used for investment in SPLI. However, for a period during 1987, an analysis was performed of the checks received for the purchase of Prime Plan, a single premium variable life product distributed through Merrill Lynch. Approximately 40 percent of the checks analyzed were from a Merrill Lynch CMA account. The Merrill Lynch CMA account combines a margin securities account, a money market fund account and a checking account maintained by a bank. More interestingly, close to 60 percent of the checks analyzed came from a regular bank checking account. One could conclude that this 60 percent (and some of the CMA checks) represent a transfer of funds from short-term liquidity into long-term savings through the purchase of SPLI.

In our past observations of Congressional tax activity, we have noted that issues perceived to be tax "problems" often generate a level of discussion such that legislation to fix the "problem" becomes inevitable, regardless of the objective merits—a snowball effect. We fear the single premium issue may have become elevated to such "problem" status. We strongly urge that all suggested alternative solutions to the supposed "problem" be carefully considered and evaluated, including the alternative of maintaining the status quo. Any new legislation should apply only to policies issued after its effective date. Our customers who currently own single premium life insurance justifiably relied on current tax law, especially if one considers that Congress thoroughly examined this issue as recently as 1984. Consumers who purchased single premium life insurance since 1984 in the expectancy of some degree of continuity and stability in the taxation of life insurance should not have the rules changed on them in the middle of the game.

Sincerely,

JOHN L. STEFFENS,
President and Chief Executive Officer,
Merrill Lynch Consumer Markets.

Mr. STARK. Would your guess be that it's probably transfer—I mean, I can't see that because they tend to be older folks buying, and I think the pattern would show that they don't buy it consistently. It isn't a normal savings pattern, but what would be your judgment?

Mr. MCCARTHY. I would suspect it's a mixture of the two. However, in terms of trying to quantify the——

Mr. STARK. If you had any figures you'd be willing to show us, it would be interesting.

Mr. MCCARTHY. Sure.

---

[2] Statement of National Association of Life Underwriters before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, March 15, 1988.

Mr. STARK. My concern is that I've heard a lot of comments lately—and I would ask this starting with Dr. Penner—about entitlements and the fact that Social Security will bust the budget. I suppose we're all aware of the fact that there might be some extra funds that the Government wouldn't have to borrow if we didn't increase Social Security payments quite as rapidly, but I have a hunch that that's a pretty marginal savings.

In other words, if you don't spend so much out of the Social Security trust fund, there might be less money that the Federal Government would have to borrow. But on margin, I can't believe that that's but a flyspeck in savings. And because we don't necessarily cut taxes—as a matter of fact, nobody has suggested that; they've suggested we cut the payouts in entitlements but don't necessarily cut the payroll taxes—and because if there were any savings, we can't spend it in any other areas—in other words, we can't take Social Security savings and spend it for public works. It has to stay in the trust fund. From an economic standpoint, wouldn't it be better if we just take all of those out of the discussion of the deficit, because they're really self-funding?

I'm not trying to lead you, but it seems to me also that the change in domestic consumption that you'd make by lower adjustment in the COLA wouldn't be very significant.

Do you have any views on that?

Mr. PENNER. Well, sir, I guess I disagree with you on that. First of all, looking at the overall budget, Social Security is, of course, gargantuan. It's about 20 percent of total spending; it's a third of nondefense, noninterest spending. So very tiny changes in that program can save you a very large amount of money.

Mr. STARK. Okay. Where do we save it?

Mr. PENNER. Pardon?

Mr. STARK. Where do we save it? I'm missing something. We don't distribute it, but it still gets collected and goes into the trust fund.

Mr. PENNER. That is correct, but that's just a bookkeeping convention. There's no need to account for it like that. If you decided to reduce outlays for Social Security, I would advocate, under current circumstances then, a comparable cut in the payroll tax and a substitution of some income tax increase for that cut.

Mr. STARK. But doesn't it have to be the whole thing, to really get any budget savings? I mean, you could cut the outlays. That doesn't get any savings unless you cut the payroll tax, and that might get you some domestic consumption.

Mr. PENNER. Well, no——

Mr. STARK. But if you substituted another tax, then you have to do all three of those steps to make the savings.

Mr. PENNER. Well, not really. I mean, the way——

Mr. STARK. Mr. Gramlich is shaking his head.

Mr. GRAMLICH. No, not true. I mean, a dollar is a dollar. If you cut Social Security spending, you raise the Social Security surplus by a dollar, and you cut the overall government deficit by a dollar, period.

Mr. STARK. Okay. And you see no economic difference in cutting a dollar that can be substituted for something else or for which there is no dedicated tax? In your opinion——

Mr. GRAMLICH. There is no economic difference, no. I mean, the only difference is that since Social Security has its own trust fund, there may be some pressures to spend that surplus at some point in the future. But cutting spending by a dollar, whether it's Social Security or any other kind of spending, is reducing the deficit by a dollar.

Mr. STARK. Even if there is a surplus in Social Security?

Mr. GRAMLICH. Yes. That's the same—you'd say the same thing about the highway trust fund or the airport trust fund or any trust fund; if you cut spending a dollar, and you don't touch revenues, the deficit goes down a dollar.

Mr. PENNER. I think, Mr. Stark, the way I look at it——

Mr. STARK. And the reverse is true then. If you raise the Social Security payroll tax without any change in Social Security distributions, you'd say we're reducing the deficit also.

Mr. PENNER. That is correct. I think a useful way to look at it is to see the Government as a great, huge conglomerate that has a number of these subsidiaries that we call trust funds. The conglomerate as a whole is running a big deficit. Some of the subsidiaries are running a profit. Any increase in the profit of a subsidiary reduces the conglomerate's deficit. It's as simple as that.

Mr. STARK. Well, no, it isn't as simple as that. You're suggesting like a conglomerate, if in running a bank or an insurance company I am required to run some surplus which by some regulatory reason is dedicated, and the stockholders aren't going to ever get ahold of it, you can't tell me that's profit until I can get it released from the regulators. So I don't know as I'll buy your example.

If you have dedicated reserves for whatever reason, whether it's a bond you have to post to do business in a State, there's no way that you can consider that a profit of the enterprise. So I'm not sure that holds.

Mr. PENNER. Well, there's no regulatory body overseeing the Federal Government in that same sense. So you all can do whatever you like, like the 400-pound gorilla, and the dedication is just an accounting convenience now which can be changed at the drop of a hat by you all. The hat would land with a pretty big thud, given the objections of interest groups, but there is technical barriers to such a change.

It is purely an accounting convention to handle these things the way we do.

Mr. STARK. Does that make more sense than to suggest, then, that you have to expense capital expenditures when you have an average debt amortization of 5 or 10 years? I mean if we made the change you could cure the deficit overnight and just account for our capital expenditures the way every other entity in the world does, and that's to spread it out over the useful life of the capital?

Mr. PENNER. Well, you make a good point, that there are many failings in the way the Federal Government accounts——

Mr. STARK. I'm trying to see whether it makes sense. From a practical standpoint, I can understand that money saved in public works might be money spent in education or not spent at all.

Mr. PENNER. That's right.

Mr. STARK. And not need any other tax.

What about unfunded medical care liabilities for Federal workers? That's not in the budget. How do you treat that?

Mr. GRAMLICH. Well, sir, there are two issues here. One is how the budget is counted, and one is what you have changed.

Now in the example you were posing before, we were simply cutting Social Security benefits, and it's clear that if we keep counting the budget the same way we have been counting, that that's going to lower aggregate spending. Those benefits are part of spending. That's going to lower aggregate spending and reduce the deficit.

Now the entirely separate question is, given the spending that we have, what you define as the deficit, and that is something—you can call together economists and lawyers and politicians, and you could argue for hours, and you could define the deficit in different ways. But if you haven't changed anything—in some sense, the problem with national saving and investment that Mr. McCarthy was talking about is not changed. All we do to change the accounting of it.

So, let us say that we cut this spending. Would that reduce the deficit? And the answer is yes, it would.

Mr. STARK. Okay. Do you see any difference between Social Security deficits or surpluses and other deficits and surpluses?

Mr. GRAMLICH. Really, the only difference is that the Social Security has a trust fund that pays for its benefits over a period of time. And as I understand it, it is now set so that the Social Security fund will have a cash balance of zero in about 70 years.

So let's suppose we just cut benefit payments and made no other change. Then what that would do, that would make that cash balance come to zero maybe in 80 years, some other time.

Mr. STARK. It would give us a short-term surplus next year.

Mr. GRAMLICH. That's right. It would cut the Government deficit and so forth. It would improve saving and investment, all of that, and it would defers the time at which way out there in the future we're going to have to raise Social Security payroll tax rates.

Mr. STARK. Yeah, but suppose we're wrong. We're not very——

Mr. GRAMLICH. Well, no. I understand that. But it would put that day off a little bit longer. That's really what it would do for Social Security.

Mr. STARK. And you're not worried that a Social Security surplus could hide other non-Social Security deficits and give us a really——

Mr. GRAMLICH. I personally am very worried about that, and I would like to see us cut the other part of the budget as well.

Mr. STARK. Okay. I would too. You can't hide Social Security deficits or surpluses with defense cuts.

Mr. GRAMLICH. That's right.

Mr. STARK. But you can do the reverse. And so there is some difference in how we treat it. And I'm just wondering, maybe not off-budget, but whether we ought to have two budgets really, and then you and I can add them up in our heads, but——

Mr. GRAMLICH. And I think—it sounds like you and I could agree that what I'll call the general Government budget—that is the non-Social Security part of the budget—that we ought to get that down toward zero, and I certainly agree with that.

Mr. STARK. Because I will tell you what I would do in a hurry is I would be glad to run defense out of a trust fund all day long. That would be fine.

Mr. GRAMLICH. But the point is that we could agree that we would like to get the general Government deficit down, we both agree with that, but it is still true that if we were to cut Social Security benefits, that would lower the Government deficit.

Mr. STARK. As I say, did you all touch in your testimony about when the recession is coming late this year or early next year? [Laughter.]

I missed that.

Mr. PENNER. There was no explicit recession in my forecast, though I think we clearly will have a slowdown this year, as compared to last, and we could come very close to a recession.

Mr. STARK. But how did you forecast long term interest rates?

Mr. PENNER. I didn't hear you.

Mr. STARK. How did you forecast long term interest rates over the next year?

Mr. PENNER. For the purposes of my discussion, I essentially used the CBO forecast and there are great uncertainties around that. It has a slight rise in long term interest rates over the next 2 years.

Mr. STARK. Mr. Gramlich?

Mr. GRAMLICH. Oh, I am not a forecaster.

Mr. STARK. What is Merrill Lynch forecasting or what is Mr. McCarthy forecasting to them?

Mr. MCCARTHY. We are forecasting that we will not have a recession in 1988. We are afraid that we could have a modest downturn in 1989, in part due to what we also expect to be a modest backing up in interest rates over the balance of this year.

Mr. STARK. Increase in interest rates, long term?

Mr. MCCARTHY. That's right, not dramatic. I would say nine and a half would probably be a worst case scenario, if only because we saw last fall, the immediate damage that higher interest can do both to the economy and some of the other markets as well. This limits the upward potential.

Mr. STARK. Nine and a half. Where are we now?

Mr. MCCARTHY. Oh, about 8½.

Mr. STARK. Okay.

Gentlemen, on behalf of the Chair and the committee, I apologize for our spastic attendance, but schedules around here are almost as confusing as economics, and I want to thank you for your patience and your dedication. Nice to have you here testifying. The committee will recess.

[Whereupon, at 4:05 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF THE
AMERICAN COLLEGE OF GASTROENTEROLOGY
TO THE
HOUSE COMMITTEE ON WAYS AND MEANS
ON
THE PRESIDENT'S BUDGET FOR
FISCAL YEAR 1989
APRIL 15, 1988

The American College of Gastroenterolgoy (ACG) appreciates the opportunity to share with the Committee the views of the gastroenterological community on the President's Fiscal Year (FY) 1989 budget proposal. While ACG acknowledges the grave status of the federal deficit and the need for budget reform, ACG must firmly oppose the proposed Medicare cuts of $1.3 billion contained in the Administration's FY 1989 budget. These reductions would be in addition to the series of cuts implemented in last year's budget reconciliation.

Over the past seven years, the Medicare program has endured a disproportionate share of federal budget cuts--the impact of which has not yet been fully realized. A comparison of actual Medicare spending and the Office of Management and Budget projected current services spending reveals that Medicare funding has been reduced by $7.9 billion since 1980. Under the Omnibus Budget Reconciliation Act of 1987 (OBRA), P.L. 100-203, Medicare again bore the brunt of federal budget cuts to human resource programs in order to meet budget targets agreed to in the November 1987 bipartisan budget agreement. OBRA reduces Medicare outlays in FY 1988 by $2 billion and by an additional $3.5 billion in FY 1989. Further reductions in Medicare, compounding a seven-year pattern of major reductions, we believe, would adversely affect the quality of care for Medicare beneficiaries.

It is ACG's position that the Medicare program should not be subjected to additional cuts in FY 1989. ACG agrees with Chairman Rostenkowski that Congress should adhere to the provisions of OBRA 1987 as it upholds the spending targets established by the budget summit between Congress and the Administration. Implementation of further reductions in Medicare at this time would be a violation of the two-year bipartisan budget agreement.

Specifically, one provision in the Administration's FY 1989 proposed budget would implement a 5 percent across-the-board reduction in the prevailing charge levels for the twelve "overpriced procedures" targeted for cuts in OBRA 1987. These procedures were reduced in last year's budget reconciliation across-the-board by two percent and up to an additional 15 percent according to a sliding scale. ACG is very concerned that upper GI endoscopy was included in last year's list of "overpriced procedures" without any systematic examination by the either the Physician Payment Review Commission (PPRC) or Congress. In fact, it was not included in either House or Senate bills and was arbitrarily added to the list of procedures during a closed conference, just before Congress passed the budget reconciliation conference report. More importantly, the affected physicians and beneficiaries were not given the benefit of a hearing or debate on the validity and/or implications of the reductions.

While the gastroenterological community is fully prepared to participate in efforts to reduce deficit spending--including savings from gastroenterological procedures--ACG opposes the inclusion of upper GI endoscopy in the list of procedures to be reduced as "overpriced procedures" in the President's FY 1989 budget proposal. ACG has offered to participate in the PPRC consensus panel process to look at coding issues, particularly grouping codes for payment purposes, and is extremely willing to work with PPRC. It would be inappropriate at this time, before further study by PPRC, Congress and affected parties, to implement additional cuts in upper GI endoscopy prevailing charge levels. There has not been adequate time for gastroenterologists, Medicare beneficiaries, Congress or the Health Care Financing Administration to realize the effects of last year's budget reconciliation.

Of the $1.3 billion in Medicare reductions proposed in the President's FY 1989 budget, Medicare Part B would absorb $300 to $330 million, after years of targeted cuts. The Deficit Reduction Act of 1984 mandated a one-year freeze on Medicare reimbursement for physicians' services, which Congress extended to a full 30 months for non-

participating physicians; under the Sixth Omnibus Budget Reconciliation Act of 1986 (SOBRA), certain limits on actual and prevailing physician charges, including maximum allowable actual charges (MAAC), were imposed. Although SOBRA increased prevailing charges by the full Medicare Economic Index (3.2%) on January 1, 1987, physicians' charges were not competitive with the rate of increase of overhead costs because the update was added to 1984 charges. Physician payment updates under OBRA 1987 are dependent on what type of service is being provided and whether the physician is participating or non-participating under Medicare. While ACG commends Congress for acknowledging the need for greater reimbursement for primary care services by updating payment under OBRA for these services by 3.6 and 3.1 percent for participating and non-participating physicians, respectively, ACG believes that further limits or reductions in physician payment under Medicare Part B should be avoided. The effects of past cuts have not yet been fully experienced, and additional reductions could adversely affect the quality of care furnished to beneficiaries and create a two-tiered system of medical care.

The Administration's proposed FY 1989 budget also provides for reductions in reimbursement for radiology and anesthesiology services by 10 percent and development and implementation of separate fee schedules for these services. Separate fee schedules as proposed by the President (and Congress in OBRA 1987) could result in fragmentation of the medical profession and undermine the effectiveness of the resource cost-based relative value scale (RVS) under development at Harvard University. PPRC supports the development of a resource cost-based RVS and will be evaluating the Harvard RVS study for suitability for a Medicare fee schedule. Congress itself has recognized the importance of the Harvard study, by including in OBRA 1987 provisions that delay until July 1989 the requirement that the Secretary of the Department of Health and Human Services develop a relative value scale as a basis for payment under Medicare, thus allowing for completion of the Harvard study and availability of its results for incorporation in a national fee schedule. Since the budget compromise agreement is valid for another year--by which time we should be close to implementing a resource cost-based fee schedule--ACG urges the Committee to oppose any major changes in the existing payment system under Medicare until the Harvard RVS study is available for review and possible implementation.

Included in the Administration's proposed Medicare cuts are significant reductions in funding for graduate medical education (GME). Specifically, direct GME payments--direct payments to teaching hospitals for the costs of services furnished by interns and residents, including salaries, fringe benefits and program costs--would be reduced to provide savings of $60 million. The adjustment factor for calculating indirect medical education payments is proposed to be reduced from 8.1 to 4.05 percent; this factor is already scheduled to decrease to 7.6 percent in FY 1989 under OBRA 1987. The indirect GME payment factor under the hospital prospective payment system provides an adjustment for the higher patient care costs incurred by hospitals with medical education programs and reflects the increased demands that residents place on other hospital staff and the tendency of residents to provide more services and conduct more tests than experienced physicians.

ACG acknowledges that reductions in the reimbursement for the indirect costs of GME may be appropriate in efforts to reduce federal spending, but only after a study has been undertaken to determine precisely what costs are due to teaching (more tests, more procedures, etc.) versus other factors (the particular types of patients a teaching hospital may attract) and only after alternative sources of funding have been identified. The entire question of how this country should finance graduate medical education has not been answered, and the commission established to address this question is not adequately funded to pursue it vigorously. Abrupt reductions in Medicare support for post medical school education could have major adverse effects on the hospitals now receiving Medicare funds, on health professionals currently in training programs, on individuals considering future careers in the health care professions and ultimately, on the general public. Before Medicare funding for GME is further reduced or eliminated, the policy question of who will pay for graduate medical education must be solved. ACG requests the Committee to resist further FY 1989 cuts in graduate medical education until there is a better understanding of exactly what Medicare is paying for, particularly in the adjustment for indirect GME costs, and until alternative sources of funding are established.

ACG commends the House of Representatives for not supporting the President's proposed FY 1989 Medicare cuts in the House budget, passed March 23. Further reductions in Medicare in FY 1989 would violate the two-year spending plan agreed to by Congress and

the Administration in the bipartisan budget summit. ACG believes that the reductions implemented by OBRA 1987 fully execute the budget agreement. Therefore, in keeping with the House-passed budget, we urge the Committee to reject the Administration's credence that Medicare savings provided under OBRA do not fulfill the terms of the budget summit. ACG recommends that the Committee continue to uphold the generally accepted understanding that P.L. 100-203 satisfies the budget summit agreement.

M-AF-0446a/jp

STATEMENT OF THE

AMERICAN RHEUMATISM ASSOCIATION

TO THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON

THE PRESIDENT'S BUDGET FOR

FISCAL YEAR 1989

APRIL 15, 1988

The American Rheumatism Association (ARA) appreciates the opportunity to share with the Committee the views of rheumatologists throughout the country on the President's Fiscal Year (FY) 1989 budget proposal. The ARA is the only professional organization of physicians and scientists devoted to the study and treatment of rheumatic diseases. While the ARA acknowledges the grave status of the federal deficit and the need for budget reform, the ARA must firmly oppose the proposed Medicare cuts of $1.3 billion contained in the Administration's FY 1989 budget. These reductions would be in addition to the series of cuts implemented in last year's budget reconciliation.

Over the past seven years, the Medicare program has endured a disproportionate share of federal budget cuts--the impact of which has not yet been fully realized. A comparison of actual Medicare spending and the Office of Management and Budget projected current services spending reveals that Medicare funding has been reduced by $7.9 billion since 1980. Under the Omnibus Budget Reconciliation Act of 1987 (OBRA), P.L. 100-203, Medicare again bore the brunt of federal budget cuts to human resource programs in order to meet budget targets agreed to in the November 1987 bipartisan budget agreement. OBRA reduces Medicare outlays in FY 1988 by $2 billion and by an additional $3.5 billion in FY 1989. Further reductions in Medicare, compounding a seven-year pattern of major reductions, we believe, would adversely affect the quality of care for Medicare beneficiaries.

It is the ARA's position that the Medicare program should not be subjected to additional cuts in FY 1989. ARA agrees with Chairman Rostenkowski that Congress should adhere to the provisions of OBRA 1987 as it upholds the spending targets established by the budget summit between Congress and the Administration. Implementation of further reductions in Medicare at this time would be a violation of the two-year bipartisan budget agreement.

The President's budget specifically proposes additional reductions in Medicare Part B outlays--estimated at $300 to $330 million--after years of targeted cuts. The Deficit Reduction Act of 1984 mandated a one-year freeze on Medicare reimbursement for physicians' services, which Congress extended to a full 30 months for non-participating physicians; under the Sixth Omnibus Budget Reconciliation Act of 1986 (SOBRA), certain limits on actual and prevailing physician charges, including maximum allowable actual charges (MAAC), were imposed. Although SOBRA increased prevailing charges by the full Medicare Economic Index (3.2%) on January 1, 1987, physicians' charges were not competitive with the rate of increase of overhead costs because the update was added to 1984 charges. Physician payment updates under OBRA 1987 are dependent on what type of service is being provided and whether the physician is participating or non-participating under Medicare. While the ARA commends Congress for acknowledging the need for greater reimbursement for primary care services by updating payment under OBRA for these services by 3.6 and 3.1 percent for participating and non-participating physicians, respectively, the ARA believes that further limits or cuts in physician payment under Medicare Part B should be avoided. The effects of past cuts have not yet been fully experienced, and additional reductions could adversely affect the quality of care furnished to beneficiaries and create a two-tiered system of medical care.

Specifically, the Administration's proposed FY 1989 budget provides for reductions in reimbursement for radiology and anesthesiology services by 10 percent and development and implementation of separate fee schedules for these services. Separate fee schedules

as proposed by the President (and Congress in OBRA 1987) could result in fragmentation of the medical profession and undermine the effectiveness of the resource cost-based relative value scale (RVS) under development at Harvard University. The Physician Payment Review Commission (PPRC) supports the development of a resource cost-based RVS and will be evaluating the Harvard RVS for suitability for a Medicare fee schedule. Congress itself has recognized the importance of the Harvard study by including in OBRA 1987 provisions that delay until July 1989 the requirement that the Secretary of the Department of Health and Human Services develop a relative value scale as a basis for payment under Medicare, thus allowing for completion of the Harvard study and availability of its results for incorporation in a national fee schedule. Since the budget compromise agreement is valid for another year--by which time we should be close to implementing a fee schedule--the ARA urges the Committee to oppose any major changes in the existing payment system under Medicare until the Harvard RVS study is available for review and possible implementation.

Included in the Administration's proposed Medicare cuts are significant reductions in funding for graduate medical education (GME). Specifically, direct GME payments--direct payments to teaching hospitals for the costs of services furnished by interns and residents, including salaries, fringe benefits and program costs--would be reduced to provide savings of $60 million. The adjustment factor for calculating indirect medical education payments is proposed to be reduced from 8.1 to 4.05 percent; this factor is already scheduled to decrease to 7.6 percent in FY 1989 under OBRA 1987. The indirect GME payment factor under the hospital prospective payment system provides an adjustment for the higher patient care costs incurred by hospitals with medical education programs and reflects the increased demands that residents place on other hospital staff and the tendency of residents to provide more services and conduct more tests than experienced physicians.

The ARA acknowledges that reductions in the reimbursement for the indirect costs of GME may be appropriate in efforts to reduce federal spending, but only after a study has been undertaken to determine precisely what costs are due to teaching (more tests, more procedures, etc.) versus other factors (the particular types of patients a teaching hospital may attract) and only after alternative sources of funding have been identified. The entire question of how this country should finance graduate medical education has not been answered, and the commission established to address this question is not adequately funded to pursue it vigorously. Abrupt reductions in Medicare support for post medical school education could have major adverse effects on the hospitals now receiving Medicare funds, on health professionals currently in training programs, on individuals considering future careers in the health care professions and ultimately, on the general public. Before Medicare funding for GME is further reduced or eliminated, the policy question of who will pay for graduate medical education must be solved. The ARA requests the Committee to resist further FY 1989 cuts in graduate medical education until there is a better understanding of exactly what Medicare is paying for, particularly in the adjustment for indirect GME costs, and until alternative sources of funding are guaranteed.

The ARA commends the House of Representatives for not supporting the President's proposed FY 1989 Medicare cuts in the House budget, passed on March 23. Additional cuts in Medicare at this time would violate the two-year spending plan agreed to by Congress and the Administration in the bipartisan budget summit. The ARA believes that the reductions implemented by OBRA 1987 fully execute the budget agreement. Therefore, in keeping with the House-passed FY 1989 budget, we urge the Committee to reject the Administration's belief that Medicare savings provided under OBRA do not fulfill the terms of the budget summit. The ARA recommends that the Committee uphold the generally accepted understanding that P.L 100-203 satisfies the budget summit agreement.

STATEMENT FOR THE RECORD

OF THE

AMERICAN SOCIETY OF INTERNAL MEDICINE

TO THE

HOUSE WAYS & MEANS COMMITTEE'S MARCH 16, 1988 HEARING

ON THE ECONOMY

AND THE PRESIDENT'S BUDGET

FOR FISCAL YEAR 1989

April 15, 1988

The American Society of Internal Medicine, an organization representing physicians nationwide who specialize in internal medicine, appreciates the opportunity to submit this statement on the Administration's fiscal year 1989 budget proposals.

Proposed Medicare Cuts in the Administration's FY '89 Budget

The American Society of Internal Medicine (ASIM) strongly opposes the Administration's call for further reductions in the Medicare program of $1.3 billion. These cuts would be in addition to the savings agreed upon by Congress and the Administration in its 1987 bipartisan summit agreement.

Over the last several years, the Medicare program has been forced to absorb major reductions in projected outlays in order to meet deficit reduction targets. ASIM is concerned that continued cuts in Medicare expenditures will have a detrimental effect on the quality and availability of patient care.

The Administration's proposal is also in violation of the bipartisan summit agreement between Congress and the Administration. That agreement provides for reductions in Medicare expenditures of $5.5 billion over a two-year period through enactment of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203). ASIM is pleased that both the House and Senate budget committees concur that no further cuts in the Medicare program are needed to satisfy the intent of this agreement.

AIDS Funding

ASIM commends the Administration for its proposed 37 percent increase in funding for AIDS research and prevention. This commitment is a positive step forward by the Administration to expand our nation's efforts in combating the spread of this deadly disease. Adequate funding is needed for counseling and testing AIDS patients, research to find a cure and develop an effective vaccine, and especially for public education regarding appropriate prevention measures, the most effective way of reducing the spread of HIV infection. ASIM supports legislation introduced by Rep. Henry A. Waxman (D-CA) and Senator Edward M. Kennedy (D-MA), H.R.3071/S.1575, to provide funding over the next three years to help states pay for voluntary HIV antibody testing and counseling.

The Administration's budget, however, fails to address the significant and unavoidable burden that the costs of caring for AIDS patients places on the U.S. health care system. To date our national health policy has left the fate of persons suffering from AIDS to the vagaries of private insurance, Medicaid, local governments and charity. Public hospitals and the Medicaid program are especially hard hit by the epidemic. An estimated 40 percent of AIDS patients are being served under state Medicaid programs; in some areas, up to 69 percent of AIDS patients are receiving Medicaid benefits. Future financing of

AIDS care will necessarily involve substantial public programs and funds. ASIM believes that the federal government should take a leadership role in assuring that adequate financial resources are committed at all levels of the public and private sectors to finance the care of AIDS patients.

Proposals to Control the Volume of Physician Services

Medicare PPOs

The Administration plans to pursue a variety of physician payment reform options to reduce Part B spending growth, including evaluation of cost control efforts made by the private sector through preferred provider organizations (PPOs). ASIM recognizes the need to develop sound policy options for addressing the increase in the volume of physician services but urges caution in proceeding with the development and implementation of a Medicare PPO proposal as a means of achieving this goal. Demonstration projects should be undertaken first in order to test the feasibility of the concept, its impact on beneficiaries and physicians, and to resolve certain operational issues. ASIM's specific concerns, based on what information is available to date on how HCFA might structure such a program, include the following:

1. **The lack of uniformity among PPOs in the private sector makes it difficult to generalize about their likely impact on physicians and their patients.** Unlike HMOs, PPOs are not yet a clearly defined alternative health delivery system and are still evolving. They differ considerably in sponsorship, structure, provider selection, reimbursement and how they conduct utilization review, and increasingly are giving way to a profusion of hybrids with HMO-like characteristics. For example, "first generation" PPOs required no risk sharing by their participating physicians. As they have evolved, however, PPOs are increasingly requiring physicians to bear some financial risk for patient care costs.

   Another departure from the traditional PPO model concerns patient freedom of choice. Although still few in number, gatekeeper plans are increasingly popular in PPOs. In this arrangement, the patient designates a primary care physician who controls referrals to specialists and approves hospital admissions. The gatekeeper physician receives a capitated payment or fee for case management. Investor-sponsored plans are most likely to use gatekeepers (36 percent), followed by insurer-sponsored PPOs (20 percent), according to a national survey of PPOs conducted in 1986.

2. **Most PPOs do not have sophisticated ambulatory review systems in place.** ASIM is concerned that HCFA is making certain assumptions about PPOs' ability to control the utilization of Part B services that are incorrect. Few PPOs have developed ambulatory review mechanisms, with most focusing on controlling inpatient costs. There is also a lack of recognized standards for treatment protocols for outpatient review.

3. **Adequate methodology and data do not yet exist to identify high-quality, cost-effective physicians.** Because the technology for comparing physician performance is not well developed, some physicians could arbitrarily be excluded from the PPO on the basis of "inappropriate" practice patterns. HCFA appears to be focusing on the ability of PPOs to distinguish between efficient and inefficient providers with little attention paid to whether this care is of high quality. The term "preferred" may wrongly imply to beneficiaries that physicians designated as such provide superior quality of care, when in fact they may not have had to submit to a rigorous credentialing process but merely agree to discount their fees. Our experience with private sector PPOs is that most do not really exclude poor quality providers because they lack the sophisticated management information systems necessary to do so.

4. **The proposal does nothing to address the current disparity between cognitive and procedural services.** Reimbursement is likely to be based on current allowable charge levels, which may in the future be negotiated downward by the PPO. (PPOs in the commercial sector typically require physicians to discount their fees an average of 20 percent; many at ASIM's urging have required a smaller discount for primary care services than for specialty services, and others have developed their own relative value scales that have addressed the

inequities between cognitive and procedural services.) ASIM is concerned that PPOs will merely serve as a vehicle to further ratchet down physician payment in general, and to perpetuate the existing disparity in cognitive and procedural services in particular. We are also concerned that the PPO proposal not serve as a vehicle to force physicians to accept mandatory assignment.

5. **Patient penalties for going outside the PPO network could provide a hardship to many Medicare beneficiaries, causing them to disrupt well-established and satisfying physician-patient relationships.**

6. **Beneficiaries may have difficulty understanding the differences between their current Medicare coverage versus HMO coverage versus PPO coverage.** Those beneficiaries who participate in HMOs, for example, often fail to understand the limits of HMO coverage, that their access to specialty care may be restricted, and that if they sign up with an HMO their personal physician is not a member of, they will have to discontinue their relationship with that physician.

7. **Having one PPO per geographic area may give the PPO or carrier a dominant share of the marketplace.** This arrangement would have a chilling effect on an individual physician's or group's ability to negotiate a fair price for their services with the PPO since there would be no competing organization they could sign up with if they thought they could negotiate a better arrangement. For this reason, the ASIM believes HCFA should contract with several PPOs in a geographic area. HCFA should also contract with existing PPOs rather than create a new, costly network of Medicare PPOs.

8. **The incentives for physician participation are weak at best.** Increased patient volume and prompt payments are the purported incentives for physicians to participate. In addition, preferred physicians may initially receive differential MEI updates and the higher prevailing charge levels used for participating physicians. ASIM is extremely skeptical about the likelihood that physician claims would be paid more promptly, based on our members' experience with private sector PPOs. If this proposal ultimately is put in place, the ASIM believes that guarantees would need to be made to insure prompt payment of claims to physicians.

For these reasons, ASIM supports well-structured demonstration projects that test the feasibility of Medicare PPOs and their impact on physicians and patients and resolve the operational issues identified above, prior to any large-scale implementation of this option.

Intensified Medical Review

The Administration's budget contains over $100 million in additional funds for more intensive review of claims. Over $50 million of this will be devoted to curbing growth in Part B expenditures. ASIM believes that utilization review by Medicare carriers and peer review organizations can play an important role in reducing unnecessary volume of services, provided that such review programs are implemented fairly and reasonably and in a manner that is as unobtrusive as possible to still be effective. A recent scientific survey of a random sample of ASIM members strongly suggests that there is a "crisis in confidence" in existing Medicare utilization review procedures. Fully 71 percent agreed with the statement "Medicare is requiring more unnecessary documentation for claims to be paid." Sixty-two percent agreed that "Medicare is increasingly rejecting claims for medically appropriate services to save money." And 65 percent rejected the notion that "Medicare is doing a better job at reviewing the medical necessity of claims and is rightfully rejecting more claims because they are unnecessary."

This crisis in confidence increases costs and greatly hinders the effectiveness of utilization review, by resulting in growing numbers of requests for "fair hearings" and reconsiderations (28 percent of all respondents indicated they had requested hearings for claim denials during the past year); an unwillingness among physicians to become involved in so-called "peer review," due to a perception that such review is inevitably skewed toward reducing costs at the expensive of quality; antagonism between the Medicare program and physicians and beneficiaries who suffer when claims are inappropriately denied; and unnecessarily obtrusive and excessive requirements for documentation of services rendered to patients. If, on the other hand, physicians

generally found utilization review processes to be valid and the utilization screens medically appropriate, there would be greater compliance with the Medicare standards, fewer denials, and fewer requests for reconsiderations and fair hearings.

ASIM believes that increased funding for medical review should be contingent on the development of more effective utilization review procedures rather than simply increasing the level and intensity of current review by the carriers. One strategy is a targeted approach that would monitor overall physician practice patterns to identify practice "outliers" that appear to be aberrant in comparison to those of their colleagues. Once identified, services provided by those physicians could be scrutinized by peer review groups in far greater detail to determine if, in fact, the care provided to individual patients was medically appropriate. This approach would likely receive support from the medical profession and be more cost effective in the long run.

Over the long term, ASIM also urges Congress and the Administration to examine the utilization review criteria and methods used by the private sector for their potential applicability to the Medicare program.

Quality of Care Proposals

ASIM supports the Administration's proposed increase in funding for peer review organizations and research on the quality of patient care and has for the past several years called for more funding for these purposes. Additional funding is necessary if PROs are to meet legislative mandates to implement new quality initiatives, such as substandard care review, ambulatory review, review of the quality of care provided by health maintenance organizations and competitive medical plans, and other program revisions. ASIM believes many of the problems its members are having with PROs stem in part from the PROs' inability to properly implement these program revisions due to limited funds. As Congress and the Administration continue to expand the review requirements of PROs, care must be taken to insure that adequate funding is provided for the new responsibilities that have been assigned to them.

ASIM strongly supports the allocation of additional funds for research on the quality of patient care. As budgetary constraints continue to squeeze the dollars available to the Medicare program, it is vitally important that the impact of program changes on Medicare beneficiaries be carefully evaluated. ASIM recommends that part of HCFA's research budget be devoted to research on the impact of the prospective payment system on the quality of patient care. ASIM's own survey of its internist members, "The Impact of Prospective Payment on Patient Care," found that after four years of delivering care under Medicare's prospective payment system, a number of serious problems persist that adversely effect the quality of care for hospitalized elderly patients. Two-thirds of the respondents said that DRGs had either "somewhat diminished" or "considerably diminished" the quality of care. Specific problems identified were premature discharges and delayed admissions of patients needing hospitalization. These findings strongly suggest that Congress and the Administration need to more closely examine the effects of DRGs on Medicare patients and make changes where necessary to insure adequate payment for, and most important, flexibility in managing and providing for the elderly's medical needs in an appropriate manner.

ASIM's survey also found that the prospective payment system has created a need for nursing home or home health care services that many communities cannot meet. Fifty-nine percent of the survey respondents reported problems with the availability of nursing homes for patients discharged from the hospital. Part of HCFA's research efforts should also be devoted to evaluating the availability of adequate post-hospital care for Medicare beneficiaries.

ASIM does have some concerns about the way PRO review is currently being carried out, and has identified several problems with the review process that Congress should address. These include:

- Inadequate time frame for medical review. ASIM believes the time frame within which physicians have to respond to pending PRO denials should be expanded. In a number of instances PROs, as a result of their own time constraints, have not afforded physicians sufficient time to locate the necessary medical records, review them and respond once the PRO has notified them of a pending denial.

- Physicians should have the opportunity to discuss pending denials with the individual physician reviewer. Individual reviewers (rather than another PRO representative) should discuss pending denials with the attending physician as they are most familiar with the case and essential medical records. ASIM also believes that this requirement would help keep reviewers accountable for their decisions.

- PRO decisions should be based on the medical merits of each case and not on pre-established quotas. Many internists believe that PRO decisions are frequently motivated by quotas established in their contracts. Although the issue of whether PROs are subject to such quotas has been hotly disputed by HCFA and the PROs, the perception remains that many PRO decisions are made to meet HCFA's expectation that medical utilization will be substantially limited through PRO review. ASIM firmly believes that medical reviews should be based strictly on the medical merits of the case and medical denials made only when there is a clear medical consensus on the appropriateness of care in those instances. In no instance should HCFA decide to terminate a PRO's contract as a result of the number or percentage of cases denied.

- Greater efforts need to be made to insure that cases under reconsideration are reviewed by the physician's peers. Although HCFA currently instructs PROs in the PRO manual to use qualified specialists in cases under reconsideration, PROs are permitted to use other physicians if using qualified specialists only "would compromise the effectiveness or efficiency of PRO review." ASIM believes that Congress through its oversight authority should require HCFA to only use peers for reconsiderations regardless of whether or not it would effect the PRO's effectiveness or efficiency.

- Denial notices should be less inflammatory. ASIM members believe the language used in PRO denial notices is often unduly pejorative of the quality of physicians' care. (For example, care is frequently termed as "unnecessary", "sub-standard", or provided in "inappropriate" settings.) Physicians may prescribe a course of treatment that they feel is best for the patient, regardless of whether it may meet PRO criteria or Medicare reimbursement standards. Further, many medical decisions are not clear cut, leaving substantial room for medical judgment. For this reason, we recommend use of the wording, "does not fulfill the criteria for Medicare reimbursement" in PRO denial letters. Since denial notices may presently unfairly characterize the quality of some physicians' care, they should not be sent to patients until the physician whose care is being questioned has had adequate opportunity to respond.

National Institutes of Health

The Administration's 1989 budget request for the National Institutes of Health (NIH) represents an overall increase of 5.4 percent over 1988, including a 6.6 percent increase for those elements associated with direct research activities. ASIM urges Congress to continue to sustain the growth of the NIH, but questions whether a 5 percent increase is sufficient to maintain and build upon existing NIH programs. The Ad Hoc Group for Medical Research Funding (a coalition of over 200 health organizations) has estimated that a 14 percent increase in NIH funding would be necessary just to maintain existing programs at current levels. Congress should carefully examine the Administration's funding request to see whether it is sufficient to maintain the viability of our national biomedical research enterprise.

Homelessness

The Administration proposes to drastically curtail support for medical care of the homeless. Current support of 109 health care centers would be reduced over 50 percent, and 59 currently funded homeless health care centers would have their funding eliminated. As a result of these cutbacks, an estimated 260,000 homeless persons will lose their access to health care services. ASIM strongly urges Congress to restore support to these health care centers. Proper diagnoses and treatment are urgently needed for many of the estimated 1-2 million homeless in America. We recommend that

Congress and the Administration allocate funds to assess the degree of the homeless problem and the adequacy of medical facilities and food and shelter arrangements for the homeless and, where indicated, improve funding for the provision of such services. The plight of the homeless is a national problem that cannot be ignored.

Medicaid

ASIM is pleased that for the first time since taking office the Administration is not proposing to cap Medicaid or to reduce federal Medicaid payments to the states. The Administration is, however, proposing to take away from the states approximately 150 million in federal funds through administrative and regulatory changes. ASIM opposes these reductions as they will put more fiscal pressure on state governments at a time when their Medicaid budgets are being severely strained by the AIDS epidemic and the growing number of medically indigent.

ASIM believes that Medicaid is underfunded and poorly organized. As a result, there are large disparities among state programs, inequitable and poor reimbursement for many covered services, and generally lower levels of care for Medicaid recipients than for other insured persons. To address these problems, ASIM believes that:

- Medicaid should be revised to establish national standards that result in uniform eligibility, benefits, and adequate payment mechanisms for services across jurisdictions.

- Medicaid eligibility standards should be expanded to include the medically indigent, i.e., those needy individuals who are not eligible for Medicaid because they do not belong to a categorically needy group. Payment for Medicaid benefits for the medically indigent should be based on their ability to pay.

- Delivery and payment mechanisms in the Medicaid program should be subject to "test of performance" criteria to insure that they are sufficient to guarantee appropriate access to quality and cost-effective care.

ASIM recommends that Congress earmark Medicaid funds that could be used to protect spouses of nursing home residents from impoverishment. Under current rules, before Medicaid will begin to cover the cost of a person's nursing home care, a couple may not have more than $2,700 in jointly owned liquid assets. H.R. 2470, which ASIM supports, would raise community spouse's minimum needs allowance to a level equal to 150 percent of the federal proverty level for a two-person family.

Medicaid in many states is an all or nothing benefit. A person or family whose income is one dollar below the Medicaid limit in their particular state receives the full benefit of the program. However, if their income is one dollar above the Medicaid limit, they receive no benefits. ASIM supports legislation to remedy this situation, introduced by Senator John Chafee, which would allow the poor or near-poor to buy into Medicaid.

Conclusion

In conclusion, ASIM appreciates the opportunity to share its views on the President's fiscal year 1989 budget proposals with the committee. We are strongly concerned that further reductions in the Medicare program could have a detrimental impact on the quality and availability of patient care, and urge Congress to reject the Administration's call for additional Medicare cuts. ASIM would be happy to work with Congress in addressing the other proposals contained in the budget, such as Medicare PPOs and PRO review.

STATEMENT OF

MICHAEL D. BROMBERG

EXECUTIVE DIRECTOR

FEDERATION OF AMERICAN HEALTH SYSTEMS

The Federation of American Health Systems is the national association of investor-owned hospitals and health care systems representing over 1,400 hospitals with over 174,000 beds. Our member management companies also manage under contract more than 350 hospitals owned by others.

Medicare Hospital Prospective Payment System

We view the major problem with the current Medicare prospective payment system for hospitals as one of budget priorities. The deficit reduction laws have resulted in disproportionate cuts to Medicare whose share of reductions has been almost twice its share of outlays. Hospitals in particular have been adversely affected.

The Part A Trust Fund has not accounted for one penny of the federal deficit. Actually, the deficit would be much higher if the trust funds were not contributing their surpluses to the deficit calculations. Notwithstanding that fact, Medicare has absorbed nearly 25 percent of all non-defense cuts and 16 percent of total budget cuts for the past seven years. The proportion of those cuts is far out of line with any sense of equitable deficit reduction because Medicare outlays represent only 7.5 percent of total federal outlays.

When prospective payment was enacted in 1983, our association strongly supported and actively worked for passage of the legislation. In fact, we first urged Congress to enact some type of prospective payment system as early as 1966 because we believed that positive incentives could improve efficiency. The DRG system has accomplished that objective. Expenditures have been cut saving the Medicare program billions of taxpayer dollars and the Medicare Hospital Insurance Trust Fund has a longer life expectancy.

The hospital industry supported a bill in 1983 which provided for fixed DRG prices. These prices were to be increased annually by an agreed upon market basket index reflecting the annual increases in the cost of goods and services purchased by hospitals.

For three years in a row the Administration and Congress have amended that law to cut by more than 50 percent the rate of increase promised to hospitals. The rationale or excuse for cuts in the DRG update in fiscal years 1985, 1986, and 1987 was the serious federal budget deficit. Hospitals responded to that argument by agreeing to participate in any fair, across-the-board budget deficit-reduction plan. Hospitals pointed out though, that defense spending was rising while Medicare was being cut at a rate nearly double its share of federal outlays.

Hospital Profitability

According to a recent study by Consolidated Consulting Group, new HCFA data indicate that Medicare profits are much lower than previously estimated and are declining rapidly. Original HCFA data from the first year of the prospective payment system (PPS-1, 1983 - 1984) projected fiscal 1988 profits at 10.0 percent. Estimates derived from the second year data (PPS-2, 1984-1985) put FY 1988 profits at 5.0 percent. Projections based on PPS-3 data covering hospital fiscal years for 1985-86 show that the average hospital will lose $1-3 on every $100 of Medicare inpatient revenues (See Exhibit One). Furthermore, about 55 percent of hospitals will lose money (have a negative margin) on their Medicare business. Simply put, even the government's own data now show that most hospitals face a loss situation by the end of 1988.

The costs of the goods and services hospitals buy will have increased almost 32 percent from 1983 to 1989. By contrast, the Medicare update factor will have increased about 13 percent (See Exhibit Two). If price increases lag almost 19 percentage points behind increases in the cost of what hospitals must buy to provide care, there is simply no way that most hospitals can generate the modestly positive margin they need to provide the quality of care that Medicare beneficiaries should have.

We urge the Committee to maintain the rate of increase at the average rate of market basket minus 2 percent enacted last year for fiscal 1989 and to return to a full market basket increase for fiscal years 1990 and beyond. Failing some method for providing adequate updates, we would urge Congress to simply admit that it cannot finance its past promises to the elderly and either raise taxes, increase copayments, establish a means test or consider authorizing hospitals to charge additional amounts to those beneficiaries who are able to pay, in order for hospitals to maintain financial solvency.

If nothing is done to change the trend toward inadequate payment updates, hospitals will be forced to reassess their support for the program. Patients will realize and react to the simple fact that they are the ones who suffer the consequences of Congress authorizing inadequate payment for services.

Factors Contributing to Falling Medicare Operating Margins

The notion expressed by some that hospital margins have fallen because costs have not been contained is not supported either by the facts or the incentives of the Medicare prospective payment system. In the early years of the prospective payment system incentives worked very well and costs were reduced. The first year of the new prospective payment system yielded dramatic cost cutting by hospitals and savings to the Medicare program. Medicare Part A expenditures for 1984 were 6 percent or $2.2 billion less than projected. Reductions in the growth of hospitals' full time equivalent (FTE) employees, the first reduction since World War II, shorter lengths of stay and fewer inpatient admissions resulted in sizeable savings to the Medicare program and improved operating margins for hospitals. However, many of those reductions, particularly those related to jobs and wages, the largest budget item for hospitals (60%), are a one time phenomenon. They cannot be duplicated every year to produce the great savings achieved during the early phases of the prospective payment system without jeopardizing quality of care.

It is worth noting, from a cost viewpoint, that hospital spending as a percentage of Gross National Product (GNP) has not increased for several years. It has remained at 4 percent of GNP while total health expenditures have risen during that same period from 9 percent to 11 percent of GNP. On a per capita basis, adjusted for inflation, Medicare payments to hospitals actually decreased by 2.5 percent from 1984 to 1987 while Medicare expenditures for non-hospital services increased 27 percent.

The Medicare prospective payment system has brought about a revolution in the health care system. The change from cost reimbursement came at a time when private insurers and employers also were flexing their buying power and pressuring hospitals to cut costs in order to reduce increases in health insurance premiums. These changes in the health care market place have had some positive, very positive, effects. However, we need to examine more closely the long term effects of some of these changes.

Several major factors are contributing to the increase in hospital expenses. Inpatient costs in 1987 have increased by 8.1 percent. Of that, 6.3 percent went to goods and services that hospitals buy (excluding capital and malpractice) and 1.8 percent went to the volume of services.

The costs of labor and other items hospitals must buy to treat the sick have been rising faster than the Consumer Price Index. While the Consumer Price Index rose 4.3 percent in 1987, prices hospitals pay increased by 6.3 percent (AHA Market Basket, September 1987 versus September 1986).

There has been a dramatic shift in the site of treatment for many Medicare beneficiaries. As modern technology and improved peer review of the medical necessity for inpatient care permit and encourage a shift to outpatient treatment, the average inpatient is a very different patient. Many procedures once performed in the acute care hospital setting are now done on an outpatient basis. Consequently, the remaining Medicare patients in acute care hospitals are sicker, and require a higher and more costly level of care.

Hospitals must provide skilled staff to treat the increasingly older and more severly ill Medicare population, at a time when we are experiencing a severe nursing shortage. Hospitals must increase wages to maintain highly competent staff. Nursing costs, a main labor cost component, are estimated to rise this year by 8 percent or more due to a rising demand for nurses in non-hospital settings, such as free standing ambulatory surgical centers and the need to keep pace with salaries in other professions, such as teaching. Hospitals must also compete with those that can provide more desirable working conditions, not the frequent night and weekend shift work required in the hospital setting.

The amount of nursing resources and skill mix of other employees required per admission is higher than ever before and is not reflected in the hospital market basket. The HCFA market basket is calculated by analyzing wages in nine service industries, eight of which are outside the health sector. Had HCFA used only hospital workers' salaries, the market basket would have been 1.4 percentage points higher in fiscal year 1988. This difference represents a shortfall of about $500 million in Medicare payments to hospitals.

Another factor leading to higher hospital expenses is the greater use of expensive new technology and procedures which in many instances result in a better outcome with less risk to the patient.
For example:

- Magnetic Resonance Imaging
- Opthalmological Laser Surgery
- Organ Transplantation
- Positron Emission Tomography
- t-PA
- Cochlear Implants
- Implantable Defibrillators

Contractual allowances (discounts in the charges for health care services) have been rising rapidly since 1985. Private insurers and employers now negotiate with providers for discounted rates. Also, private payers will no longer bear the cost of caring for America's uninsured population. Consequently, hospital losses incurred by charity care and bad debt have been rising steadily. The amount of uncompensated care provided by hospitals has grown from $4.7 billion in 1983 to almost $7 billion in 1986, representing 5 percent of their gross patient revenues.

Conclusion

The Federation of American Health Systems supported the enactment of a prospective payment system as a way to provide hospitals the correct incentives for providing quality care at an efficient price. Most significantly, the response of hospitals to the new incentives under PPS has resulted in enormous savings to the Medicare program, and prolonged the life of the Medicare Trust Fund well beyond the next decade.

Hospitals have contributed more than their fair share toward deficit reduction. Hospital operating margins under Medicare are declining rapidly -- to the point where more than 50 percent of the nation's community hospitals are expected to lose money in 1988 from the costs of treating Medicare patients.

The increases in discounts to private payers and in the costs of uncompensated care is evidence that it has become more difficult to shift costs to the private sector. This inability to have private payers absorb the shortfall produced by continuing underpayments from the Medicare program and the large, growing indigent care population will exacerbate the already deteriorating operating margins of hospitals.

We urge the Subcommittee to refrain from amending the Medicare PPS system during 1988 in order to allow hospitals to digest the hundreds of amendments passed during the past several years. Further cuts in PPS payments would adversely impact quality and access to care for millions of Americans, the elderly and non elderly alike.

We urge the Subcommittee to study major restructuring of the Medicare program so that action may be taken next year to assure access by all Americans to quality care. Specifically our nation must reach a public policy agreement on protection for 37 million uninsured and adequate financing of care for beneficiaries of existing programs.

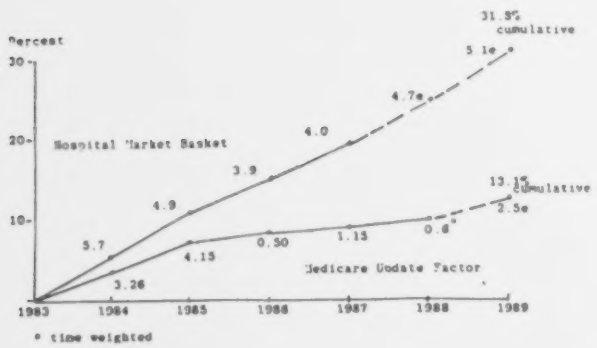
If Congress concludes that the budget deficit does not allow government to meet these needs, then other mechanisms must be utilized. If the surplus in the Medicare Part A Trust Fund is used to reduce the federal deficit, even though the Medicare hospital benefit has not contributed one cent to the national debt, then one way to provide fair and adequate payment for quality hospital care is to ask those beneficiaries who are able to pay more for their care to do so.

This can be done by taxing the value of the benefits, a progressive, means testing approach. Another way to restructure the program is to broaden the private insurance options available to beneficiaries. We also urge a demonstration program to provide all new beneficiaries -- those reaching age 65 next year -- the option to keep whatever private insurance they have with Medicare paying all or part of the premium based on the same standards used to pay Medicare HMO's or MIG's.

We urge the Subcommittee to end the annual charade of using budget reduction targets as a justification for inadequate payment. Unless we admit that inadequate funding leads to inadequate care, we will see the system deteriorate.

EXHIBIT TWO

Update Factor Vs. Increase in Hospital Input Costs
FY 1984-89



KELSO
& COMPANY

Testimony of Jeffrey R. Gates
before the Committee on Ways and Means
U. S. House of Representatives
March 15, 1988
Hearing on the Economy and The President's
Budget for Fiscal Year 1989

Expanding Capital Ownership is Essential to Reducing Deficits

In the face of demographic trends, this Committee must consider a new approach to entitlements — which now account for half of total budget outlays. Otherwise the population's shifting age profile will result in growing fiscal strains, particularly as the "baby boom" generation (many now in their 40's) becomes the "senior boom".

For example, the U.S. workforce is now saddled with an obligation approaching $10 trillion in unfunded liabilities in Social Security, Medicare and Federal pensions. This debt (the difference between the benefits due today's workers and the taxes workers are slated to pay for them) amounts to a $100,000 hidden tax on every employed person, a tax that will be levied primarily on our children.

Current action to address these long-term budgetary concerns can exploit what Federal Reserve Board Chairman Alan Greenspan calls the "wedge effect" arising from fiscal savings that tend to grow over time. Controlling the growth in such outlays, Dr. Greenspan concedes, will take "bold, controversial action" — action that Congress and the Executive Branch thus far have been reluctant to take.

The Input Distribution Problem

This demographics-driven fiscal trend will not become more favorable unless the Committee addresses the underlying forces behind this trend. Diagnosing the illness is simple enough, it is in prescribing the cure that the Committee must be willing to recommend bold, controversial action.

The simple truth of our fiscal malady is that far too few Americans have an opportunity to accumulate assets sufficient to maintain them. In a market economy, where outtake is based on input, people must accumulate either economic inputs or political inputs.

Economic inputs (i.e., physical and financial capital) entitle people to a market-derived income (i.e., dividends, interest and capital gains). Political inputs (i.e., political strength) entitle people to a politically-derived income (i.e., entitlements: income redistributed by government from those to whom market forces would otherwise have directed that income).

Americans rightfully feel entitled to a mix of economic policies that will not leave them impoverished. If that mix fails to adequately empower them with income-producing economic inputs over a working lifetime, then they will continue (rightfully) to resort to their political inputs to maintain a decent standard of living. To expect otherwise is fiscally naive.

Thus, in order for this Committee to credibly recommend a reduction in entitlements over the long-term, it must simultaneously recommend long-term policies designed to enable a broad base of Americans to accumulate substantial income-producing assets. The opportunities available for achieving such a goal are quite promising. For example, the U. S. economy currently finances more than $400 billion per year in new plant and equipment. At that pace, we will bring on line approximately $8 - $10 trillion of new, income-producing inputs between now and the year 2010 when the first baby boomers reach age 65. None of those assets are yet owned by anyone.

Yet unless this Committee recommends changes in how we finance capital assets, today's techniques of capital finance guarantee that fully half of that $10 trillion in income-producing economic inputs will be financed for the already wealthiest one to three percent of U. S. households.

Today's "Closed System" of Capital Finance

The bulk of the economy's income-producing assets are held in corporate form. According to 1983 Federal Reserve data, 58.4% of corporate stock is held by the wealthiest one percent of households. The top 0.5% own 45.6%, while 89.9% of corporate stock (plus 88% of bonds and 90.9% of other business assets) are owned by just 10% of households (excluding the 22% of stock held in pension trusts).

This disturbing ownership profile actually understates wealth concentration because: (a) it is based on 1983 data utilizing earlier research, and (b) that research fails to reflect the effect of either the investment incentives enacted in 1981 or the subsequent dramatic increase in mergers, acquisitions, recapitalizations, stock redemptions, and leveraged buyouts — all of which tend to further concentrate capital ownership. For example, in 1982 the average wealth of the "Forbes 400" wealthiest individuals was $200 million; by 1987 average wealth topped $550 million.

Government debt securities (another income-producing asset) are also concentrated in relatively few households. The U.S. Treasury recently estimated that, of those securities held by individuals in the U.S., 93% are owned by 10% of the population while 71% are held by just two percent. That "wealth" totalled $900 billion in 1980; it now exceeds $2,400 billion and legislation already enacted ensures it will soon reach $2,800 billion. Income earned on that form of wealth (i.e., taxpayer-provided interest payments) totalled $83 billion in 1980; last year that tax-free interest income exceeded $200 billion.

Expanding access to the ownership of tomorrow's income-producing assets requires legislation designed to open today's "closed system" of capital finance. This "closed system" results from the fact that today's corporate finance utilizes only three sources of funds: (a) retained earnings — which create no new capital owners, (b) tax benefits (primarily depreciation) — which likewise create no new owners, and (c) debt — which (with the aid of tax benefits) acquires more capital for existing owners (except, of course, in leveraged buyouts and recapitalizations). This "closed system" of finance explains why the capital asset base expands while the capital ownership base does not. (Accompanying materials document this closed system.)

Sales of new equities have never been a significant source of net new funds nationwide. Plus, realistically, it is primarily the beneficiaries of this "closed system" who have the discretionary income (i.e., from their capital inputs) to buy those equities. In the past several years, equities have turned substantially negative, with corporations redeeming far more stock than they have issued, thereby further concentrating capital ownership.

The Federal Reserve is a partner in the process that perpetuates this "closed system" — by facilitating bank credit to fuel this system and by accommodating deficits incurred to finance tax benefits that feed this system. For example, from 1975-82, corporate tax savings from the two primary capital financing tax benefits (i.e., depreciation and the investment tax credit) totalled $1,208 billion (not yet reflecting the legislative largesse of the investment incentives enacted in 1981). Given the current capital ownership pattern, approximately half of those tax savings (i.e., $604 billion) was used to finance additional income-producing assets for the already wealthiest one percent of U.S. households.

Left unchanged, this so-called "level" playing field of capital finance will continue to ensure that only a few households will ever participate significantly in the economic security of capital ownership. Continuing that widespread lack of capital ownership participation in our capitalist system, in turn, implies a continuing (and increasing) call for governmental redistribution of the income that property rights in a market economy will otherwise distribute among those few who own productive property. That redistribution process, in turn, is the fiscal Achilles Heel of our private property system. Private property capitalism can only work well with a broad base of capitalists.

Corporate Finance and Fiscal Foresight

If this Committee is to achieve this much-needed "wedge effect" in long-term budgetary savings, it must recommend a mix of long-term policies and programs that will ensure (in a voluntary, non-redistributive manner) a broader sharing in ownership of this nation's income-producing capital.

There is no reasonable alternative if market mechanisms are to be empowered to do an adequate job in directing income (versus the redirection implied in entitlement programs). Continued reliance on current techniques of capital finance can only guarantee steadily worsening fiscal pressures, not only from entitlement programs but also from increased pressure for job creation through public spending (e.g., defense spending and other fiscal-funded employment).

Happily, there is available a promising technique of finance that, if greatly expanded, could provide a primary means for empowering the employed to accumulate significant assets over a working lifetime. Employee Stock Ownership Plans (ESOPs), the legislative legacy of retired Senate Finance Committee Chairman Russell Long, offer tax incentives for corporations to borrow money to acquire their stock in trust for employees.

Unfortunately, because the incentives are still so modest, only one percent of corporate equities are now held in ESOPs and only a few of the many recent leveraged buyouts include employees as eventual capital owners of these huge ownership-transfer financings.

The ESOP concept recognizes that policymakers must find a way to pierce this "closed system" if a broad base of Americans are to be economically empowered by their economic system. ESOP financing recognizes that capital assets are seldom bought; rather, they are more often financed, paid for with earnings generated by the assets acquired (the financial logic that makes possible leveraged buyouts).

In order for this Committee to address the budgetary implications of today's demographics, it is critical that it consider the fiscal lunacy we face if this "closed system" is allowed to continue (as it was in major tax policy initiatives endorsed by this Committee in 1981, 1982, 1984 and 1986). Policies must be formulated to encourage the benefits of capital financings to be more broadly spread. If this Committee chooses to continue to do nothing, it is choosing to perpetuate a fiscal nightmare that can only worsen.

ESOP financing is only one approach. Other economic relationships can also be adapted to this economic empowerment concept. One of the most promising approaches is to encourage public utilities to be financed so as to create capital ownership for both employees and consumers. Others are addressed in Louis and Patricia Kelso's Democracy and Economic Power (1987).

Whose $10 trillion?

The tax code is but one area in which this fiscal foresight could be better exercised. For example, why allow corporate taxpayers the full deductibility of the interest expense associated with ownership-transfer indebtedness (such as recapitalizations and leveraged buyouts) unless some significant portion is financed through an ESOP? Why allow the incentive element of depreciation (an interest-free loan from taxpayers to shareholders) unless some portion of that fiscal-financed corporate cash flow generates capital values for someone other than those already overly enriched by the current "closed system" of finance?

Similarly, corporate tax rates could provide a preference for those companies that economically empower their employees. Business owners could be encouraged to leave their companies to those who helped build them. The full tax exemption now allowed on the earnings of pension trusts (now a principal source of financing for leveraged buyouts) could be limited unless a portion of those assets are invested in ESOP-type notes.

Any area where government policy facilitates capital finance is an area with potential for broadening capital ownership. For example, government contracts, loans and loan guarantees could be limited to ownership-expanding companies. Antitrust policy could favor mandating divestitures via ESOP financing.

Similarly, Social Security trust fund accumulations could be partially invested in ESOP notes. Trust fund collections are expected to exceed outlays by $36 billion this year, growing to $200 billion by 1990, $1,300 billion by the year 2000 and more than $4,500 billion by the year 2010. Rather than the current fiscal ruse of "investing" those funds solely in government debt securities, the funds could be invested also in debt used to finance private, ownership-expanding companies.

Tax, fiscal and monetary policy are an interrelated whole in maintaining the populace's asset-impoverished condition. Monetary policy is potentially the most powerful ingredient in fashioning the needed cure. For example, the Federal Reserve could prefer ESOP notes at its discount window or could offer more favorable reserve requirements for bank notes that support this economic empowerment policy.

In short, conventional financing techniques could be transformed so that the capital of current owners is protected while newly-financed capital and voluntary transfers of capital ownership create a steadily broadening base of economically autonomous households.

Fiscal pragmatism mandates that this Committee ask for whom today's investment tax policies will finance tomorrow's $10 trillion in new plant and equipment. It should also ask

who will be economically empowered by the still booming market in mergers, acquisitions, recapitalizations, stock redemptions and leveraged buyouts (totalling more than $1 trillion in capital transfer financings over just the past five years).

We are rapidly headed toward the wrong future, a future in which the need for a more contemporary mode of economic opportunity is glaringly apparent, yet policymakers continue to pretend that job opportunities alone are the answer to our economic ills.

Labor-saving technology is turning the labor market into a place of churning dislocation, downgrading and displacement, overturning traditional work and career patterns while raising serious questions not only about inadequate growth of future consumer buying power but also about loss of opportunities for upward economic and social mobility.

Job opportunities alone are no longer the answer. Our middle class is shrinking and, for the first time in U.S. economic history, a rising generation is assured of a lower standard of living than their parents. Americans need a more relevant mode of economic participation. They need a political culture concerned and competent enough to insist upon the use of capital financing techniques that will adequately connect them to their economic culture.

We need an economic policy that reflects the technological reality of economic participation in a post-industrial economy. That requires a tax policy that will ensure that this nation's technology (embodied in its productive capital) is financed in such a way that it will economically empower a broad base of those whose culture gave rise to that technology.

Capital finance is itself a type of technology. For example, its practitioners use technological terms to describe its workings, such as "leverage" — from mechanical technology and cash "flow" — from hydraulic technology. Today's financial technology can be adapted so that it operates to the benefit of many households rather than just a few. Only in that way can tax policy promote market-based, self-sustaining economic flows and minimize otherwise essential governmental redistribution.

We must move quickly if we are to reverse the trends that threaten our market economy. In a world where the bulk of goods and services are produced not by the efforts of labor but by the operation of capital instruments, and where technological change relentlessly sharpens that disparity, economic policy (including tax policy) is long overdue in recognizing that economic opportunity must include the opportunity to accumulate a viable holding of productive capital.

Systems-Wise Finance

Today's "level playing field" of capital finance endangers the very market mechanisms it avows to protect. A truly systems-wise approach to our fiscal future must recognize that our capitalist system requires a far more rational approach to capital finance, an approach that favors those financing techniques that strengthen rather than further imperil the system's ability to distribute income based on market mechanisms.

Social institutions (including the institutions and conventions of finance) are a bit like evolution: they change in bursts, experiencing long periods with very little change interspersed with periods of rapid, often intense change. Our social institutions of capital finance are badly in need of an evolutionary change, a change totally dependent on political will.

Tomorrow's fiscal conditions are born out of today. Today's opportunities for widespread economic empowerment cannot be foregone without assuring increased fiscal pressures in the future. Today's capital financing policies are unsustainable. They will be changed. The only question is how. The only need is leadership, and particularly leadership from this Committee.

With fiscal foresight and political courage, this Committee, by recommending policies supportive of widespread capital accumulation, can lay the foundation for a steady decline in long-term budgetary outlays. In addition to reaping the dividends from lower interest rates available from reassured financial markets, a commitment to this positive new trend could also create a renewed sense of optimism and enthusiasm among the work force, an ingredient that can only help as we adjust to an increasingly global economy.

DOCUMENTING THE "CLOSED SYSTEM" OF CAPITAL FINANCE

I. The capital ownership benefits of capitalism are not widely shared.

NOTE: According to a 1986 Report by the U.S. General Accounting Office, 89.9% of corporate equities (88% of bonds and 90.9% of business assets) are owned by just 10% of households. The top 1% of households owns 58.4% of corporate shares. The top 0.5% owns 45.6%. Figures include shares owned directly through mutual funds and exclude holdings of pension trusts (which hold 21.7% of corporate shares). (See Exhibit A.) Note that these figures understate wealth concentration because (a) they are based on 1983 research utilizing earlier data, and (b) they do not fully reflect the effect either of investment tax incentives enacted in 1981 or of the subsequent dramatic increase in mergers, acquisitions, recapitalizations, stock redemptions and leveraged buyouts. Note that of the government debt securities held by U.S. individuals, 93% are owned by 10% of the population; 71% are held by just 2%. That "wealth" totalled $900 billion in 1980; it now totals approximately $2400 billion and lesislation already enacted insures it will reach $2800 billion. Total income received from these securities (i.e., taxpayer-provided interest payments) totalled $83 billion in 1980, increasing to $203 billion in 1986.

II. The only feasible approach to fostering widespread sharing in the ownership benefits of free enterprise is to utilize corporate earnings (and tax benefits) to finance capital acquired for employees with borrowed funds.

NOTE: Practically all corporate funds are provided through three sources: (1) retained earnings, (2) tax benefits and (3) debt — none of which create any new owners. This "closed system" of finance explains why the economy's capital base expands while its capital ownership base does not. (See Exhibit B.)

III. Few taxpayers share in the ownership benefits of capital financing tax policies.

NOTE: From 1975-1982, corporate tax savings from the two primary capital financing tax benefits (i.e., depreciation and the investment tax credit) totalled $1,208,000,000,000. Given today's capital ownership pattern, roughly half of those tax savings ($604 billion) were utilized to finance additional income-producing assets for just 1% of U. S. households. (See Exhibit C.)

IV. Economic policy needs to encourage a non-redistributive method of expanding capital ownership; not taking one person's capital to give it to another but instead encouraging our economic future to be financed so that more people have an ownership stake and encouraging transfers in ownership to be financed to create a broader base of capital-owning households.

NOTE: Annual capital expenditures for new plant and equipment nationwide now total approximately $400 billion per year — approximately $5-6 trillion in new and replacement capital to be financed by the year 2000 ($8-10 trillion by the year 2010). If policymakers do nothing, the existing "closed system" of finance will ensure that half of that will be owned by just 1-3% of households. (See Exhibit D.)

V. Economic policy should encourage a financing technique that broadens the ownership benefits attributable to mergers, acquisitions, recapitalizations and leveraged buyouts.

NOTE: Such transactions totalled $35 billion in 1980, skyrocketing to almost $200 billion in 1986 — consuming enormous amounts of tax benefits and utilizing a significant portion of the economy's credit capacity while transferring phenomenal quantities of income-producing assets to a few managers, investment bankers and already- wealthy investors.

EXHIBIT A

Table 4.1: Assets of All Households and of the Wealthiest Households, 1983

Type of asset	All households amount[a]	Percent of total for Wealthiest households: Top 0.5%	Top 1%	Top 10%
Trusts	$495.7	77.0%	81.6%	95.1%
Corporate stock[b]	1,006.0	45.6	58.4	89.8
Bonds	328.1	41.3	49.6	88.0
Business assets	2,274.6	39.0	51.6	90.9
Money market accounts	265.0	15.9	22.5	58.8
Real estate	5,355.0	14.9	19.3	49.2
Land contracts	111.0	13.9	15.2	50.4
IRAs and Keoghs	142.2	13.0	21.1	67.3
Checking accounts	115.9	9.7	17.2	46.3
Insurance cash surrender value	259.8	6.7	10.5	34.9
Certificates of deposit	383.1	4.8	10.7	49.9
Savings accounts	189.5	2.1	5.2	31.1
Automobiles	359.5	1.6	3.0	20.1
Miscellaneous	201.1	15.2	22.1	70.2
Gross assets	11,486.4	24.8	31.8	83.5
Net worth	10,038.9	28.7	34.3	87.92

[a]In billions of dollars

[b]Including stock owned directly or through mutual funds, but excluding holdings of pension plan trusts

Source: U.S. Congress, Joint Economic Committee, The Concentration of Wealth in the United States: Trends in the Distribution of Wealth among American Families (Washington: Joint Economic Committee, 1986), p. 24. The figures in the table are based on revised estimates provided to us by the Federal Reserve Board following publication of the Joint Economic Committee report.

ESOPs appear to provide a broader distribution of stock ownership than generally prevails (not accounting for pension funds or insurance company holdings). ESOPs are subject to the Internal Revenue Code coverage and nondiscrimination rules applicable to all qualified employee plans. Thus, broad participation in ownership of the sponsoring corporation's stock is a condition for corporate use of tax advantages related to ESOPs. Based on data from the IRS, the median rate of employee participation for all ESOPs is nearly 71 percent. This proportion does not vary much among the types of ESOPs, although the median for tax credit ESOPs, less than 63 percent, is somewhat lower than for other types. Assuming that the employees of firms with ESOPs include workers who differ widely in levels of wealth and income, then the high proportion of these workers participating in stock ownership through ESOPs suggests that these plans do broaden stock ownership within sponsoring firms.

EXHIBIT B

Table 7

Major Corporate Tax Savings from Investment Credit and Depreciation Deduction 1975-82[a]

	1975	1976	1977	1978	1979	1980	1981	1982	Total
Investment credit									
Total allowed	$6,459,746	$9,152,712	$11,018,404	$12,897,172	$14,614,672	$15,102,812	$18,887,286	$17,112,702[b]	$105,485,506
Tentative	8,586,453	11,265,727	14,011,620	15,819,273	19,040,576	20,852,667	26,001,771[b]	24,659,306	142,259,193
TR	1,170,160	209,716	98,265	51,150	7,586	d	d	d	1,539,095
IRE	7,311,960	10,608,602	13,285,657	15,010,111	18,026,111	19,765,894	24,614,579[c]	25,146,056[c]	133,788,152
1% ESOP	104,151	447,391	570,919	645,745	806,461	859,401	1,090,614	1,173,053	5,698,157
0.5% ESOP	d	d	78,759	110,267	180,275	196,117	258,870	297,761	1,121,669
Patrons' regular	d	d	d	d	20,141	32,035	38,108	22,036	112,320
Depreciation deduction	$88,295,660	$91,761,989	$106,972,492	$121,299,900	$138,061,915	$157,145,838	$186,195,048	$211,179,160	$1,101,112,196
Maximum tax rate	48%	48%	48%	48%	48%	48%	46%	46%	
Estimated tax savings	$41,421,919	$45,005,755	$51,346,892	$58,223,952	$61,508,481	$72,370,081	$85,649,722	$98,062,614	$515,590,216

Source: Statistics of Income, Corporation Income Tax Returns, Internal Revenue Service.

[a]Dollars current in thousands.
[b]Because of a change in the statistics-of-income reporting procedures, these numbers are not perfectly comparable to the numbers in the tentative investment credit category for previous years. These figures come from a slightly different SOI category but closely approximate the actual figures.
[c]This category was not reported in SOI for 1981 or 1982. The numbers reported here represent the difference between the tentative investment credit and the total of the ESOP credits plus the patrons' regular investment credit for each year.
[d]Not applicable.

Exhibit B

Table 5

Source of Funds: Nonfarm, Nonfinancial Corporations
for Selected Years 1955-85[a]

	1955	1960	1965	1970	1975	1980	1981	1982	1983	1984	1985
Total	$52,660	$48,622	$91,840	$102,144	$156,953	$335,231	$364,155	$309,360	$436,349	$482,597	$449,520
Internal	55.9%	72.8%	61.7%	60.4%	76.2%	58.5%	63.3%	75.7%	64.3%	69.4%	79.0%
Retained earnings	22.4	16.5	20.8	7.4	21.7	14.6	12.6	3.3	4.3	7.1	5.5
Capital consumption allowance	36.1	54.8	35.4	50.6	59.8	50.1	52.0	66.9	49.3	47.3	53.1
Iva and cca[b]	-7.1	-4.7	2.7	-4.0	-13.5	-17.1	-8.1	-1.8	5.0	10.2	15.2
Foreign earnings	4.5	4.2	4.8	6.4	8.3	8.9	6.7	7.2	5.7	4.8	5.2
External	44.1%	27.2%	38.3%	39.6%	23.8%	41.5%	36.7%	24.3%	35.7%	30.6%	21.0%
New equity issues	3.3	2.8	[c]	5.6	6.3	3.8	-3.1[d]	3.7	6.5	-16.0[d]	-18.9[d]
Debt	16.0	22.0	20.0	28.9	11.3	23.3	28.3	22.6	13.6	36.4	31.8
Other	24.8	2.4	16.1	5.2	4.2	16.3	11.6	-2.1	15.6	10.2	8.2

Source: Flow of Funds Section, Federal Reserve Board.

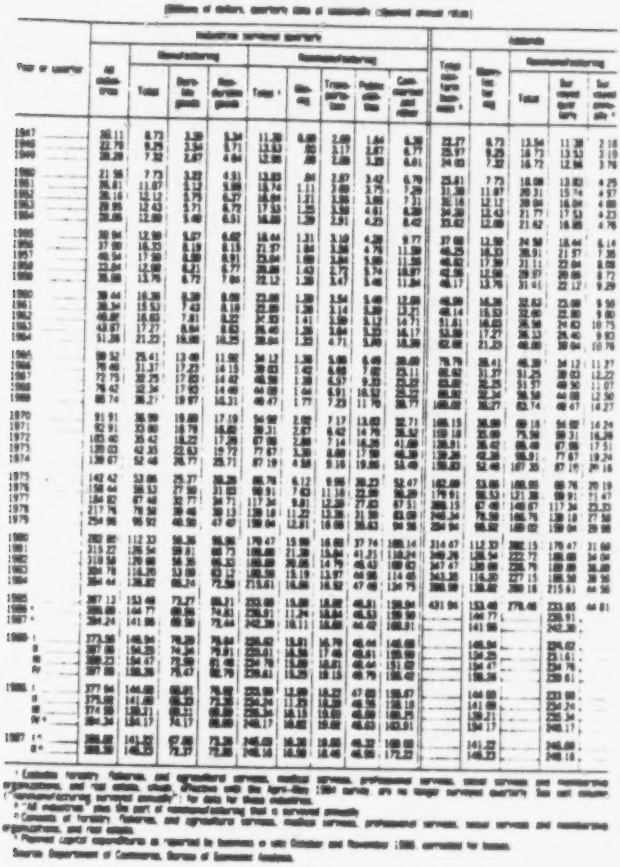
[a]Dollars current in millions, seasonally but not annually adjusted for inflation. All figures based on quarterly estimates, except 1985 based on first-quarter estimates only.
[b]Iva = inventory valuation adjustment; cc = capital consumption adjustment.
[c]Less than 0.05%.
[d]Indicates firms bought more stock than they issued.

EXHIBIT C

EXHIBIT D

TABLE B-31.—*Business expenditures for new plant and equipment, 1947–67*

(Billions of dollars, quarterly data at seasonally adjusted annual rates)



HOW TO EXPAND ECONOMIC PARTICIPATION

The following material summarizes a few of the approaches available for expanding economic participation by expanding participation in capital ownership. These recommendations focus on proposals designed to encourage this participation through the employment relationship generally and specifically through the encouragement of Employee Stock Ownership Plans (ESOPs). Note, however, that other economic relationships could also be adapted to this ownership participation concept (for example, encouraging utilities to be financed so as to create stock ownership among both employees and consumers).

I. Transform Existing Tax Benefits Although it may be difficult in today's fiscal climate to enact new tax incentives to expand participation in capital ownership, it is possible both to raise revenue and to expand capital ownership by transforming existing tax benefits. For example:

(1) Tax Code-assisted capital transfer financings. Eliminate the corporate tax deduction for interest expense incurred for capital transfer financings (e.g., mergers, acquisitions, recapitalizations and leveraged buyouts) unless a prescribed portion (e.g., 25%) is financed through an Employee Stock Ownership Plan (ESOP). Could be limited to transactions above a certain size. Valuation criteria associated with an ESOP's participation in multi-investor transactions must be consistent with market reality.

(2) Incentive element of depreciation. Require that a substantial portion of the incentive element of the incentive depreciation system be structured to expand capital ownership. Thus, a corporation would qualify for the incentive portion of this taxpayer-financed investment subsidy (essentially an interest-free loan from taxpayers to shareholders) to the extent that a significant portion of the capital being financed creates capital ownership for employees. Companies wishing to continue to expand without expanding ownership could continue to have access to a straight-line depreciation schedule based on the true economic life of depreciable assets (i.e., without the taxpayer-funded subsidy). Could be limited to companies above a certain size.

(3) Corporate tax rates. Provide a sliding corporate tax rate, with lower rates available for those companies maintaining a prescribed level of employee ownership. This ownership participation level could begin low (e.g., 5%) and increase over a period of years. Could be limited to companies above a certain size.

(4) Pension Assets. Impose a tax on the currently tax-exempt earnings of defined benefit pension plans unless a prescribed portion of such assets are invested in notes representing ESOP financing. Could be limited to plans above a certain size.

(5) Savings incentive linked to employee stock ownership. The $7,000 limit for 401(k) plans could be reduced to $5,000, allowing the additional $2,000 deduction provided that amount is invested in employer securities for at least three years. Note that the 1986 Senate Finance Committee tax reform bill included a provision allowing an additional $2,500 for 401(k) contributions to ESOPs (for a total of $9,500).

(6) Greed tax. Certainly a wealth tax should be avoided yet when personal wealth accumulations reach what anyone could agree is obvious greed, a limitation is appropriate (e.g., a 25% tax on personal accumulations in excess of $250 million). An exemption could be provided for anyone able to prove their ability to "take it with them."

(7) Ownership Impact Report. Whenever a tax initiative is proposed that impacts capital investment, require an estimate of both the revenue impact and the ownership impact. Had Congress understood both in 1981, it is difficult to imagine it would have approved such deficit-financed legislative largesse.

II. Other Useful Ways to Expand Participation in Capital Ownership:

(1) Extend the "ESOP rollover" provision - to stock held in publicly traded companies, thereby allowing shareholders to defer capital gains tax on the sale of their stock to a company's ESOP provided that, after the sale, the ESOP holds at least 30% of the company's stock.

(2) Capital Gains Tax - provide a reduced capital gains tax for those selling their stock to an ESOP. Note that this concept was approved by the Senate in 1984 requiring that, after the sale, 50% of the company's stock be owned by 50% of non-management employees. A similar bill introduced in 1981 required, in addition, that the company maintain an R&D budget averaging 2.5% of gross revenues for the 3 years prior to the sale.

(3) Dividend Deduction - allow a partial deduction for dividends paid provided the paying corporation maintains a prescribed (and increasing) level of employee stock ownership. Current law allows a corporate deduction for dividends paid only on ESOP-held stock provided those dividends are either paid out currently to employees or used to repay an ESOP loan.

(4) Investment Tax Credit - if restored (again), link to ESOP (e.g., 75% of the tax benefit reflected in company stock for employees). Thus, a company could qualify for this 100% taxpayer-financed investment subsidy but only provided that a substantial portion of the capital values financed are financed for employees.

(5) Charitable Business Transfers - treat an ESOP as a charitable organization for income, gift and estate tax purposes (approved by the Senate Finance Committee in 1981), thereby encouraging business owners to leave their companies to those who helped build them.

(6) Subchapter S Corporations - allow Subchapter S Corporations to establish ESOPs.

III. Other Approaches:

It is also possible to encourage ESOP-type financing to get more "bang for the buck" out of existing government programs. For example, ownership-expanding initiatives within the jurisdiction of other Committees include:

(1) Government Contracts - require that a portion of asset financings attributable to taxpayer-funded contracts (e.g., defense contracts, government facility service contracts, environmental clean-up contracts, etc.) be financed so as to become partially employee owned (also an approach to stem fraud, waste and abuse while stimulating motivation and productivity).

(2) Government Loans and Loan Guarantees - require as a condition that employees of assisted companies be included among those for whom taxpayers provide such capital financing assistance.

(3) Government Licensing - require as a condition of granting government licenses (a type of capital asset) or access to public assets (e.g., broadcast licenses, drilling/mining rights, asset sales etc.) that a substantial portion of those taxpayer-granted capital assets become partially employee owned.

(4) Antitrust Policy - as part of antitrust divestiture orders, provide a preference for divestitures that are ESOP financed.

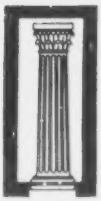
(5) Trust Fund Investments - require that a portion of the surplus accumulating in the Social Security trust fund be invested in ESOP notes.

(6) Preferred Federal Reserve Discounting - where loans are structured to expand ownership of new productive assets, allow the notes of member banks to be discounted at a preferred interest rate and/or offer more favorable reserve requirements.

(7) Ownership Impact Report - whenever government undertakes any activity facilitating capital investment (e.g., providing tax benefits for investment, granting contracts, granting leases for off-shore drilling, etc.), require a report indicating how that activity impacts capital ownership.

(8) Privatization - utilize ESOP financing to enable a substantial portion of privatized companies to become employee-owned (e.g., with government taking a note for that portion), possibly with the balance being sold to the public. In July 1986, the U. S. Office of Personnel Management announced their Federal Employee Direct Corporate Ownership Opportunity Plan (FED CO-OP), an alternative contracting out approach under which employees could (via ESOPs) become shareholders in private companies - primarily government service providers.

NOTE: Other ownership-expanding techniques of finance are developed in Louis and Patricia Kelso's Democracy and Economic Power (1987).



NATIONAL COMMITTEE TO PRESERVE SOCIAL SECURITY AND MEDICARE

2000 K Street, N.W., Suite 800, Washington, D.C. 20006 (202) 822-9459

I am James Roosevelt, Chairman of the National Committee to Preserve Social Security and Medicare. In that capacity, I represent more than five million members with a stake in the Administration's budget proposal for Medicare. Past Administration budgets have had bad news for our members with proposed increases in out-of-pocket costs for Medicare. Unfortunately, this budget is no different despite the press characterization of the budget as non-controversial.

The National Committee strongly urges the Ways and Means Committee to reject the Administration's budget proposal permanently to raise Part B premiums to cover 25 percent of program costs. Furthermore, we ask you to reverse the Senate-sponsored amendment to last year's reconciliation bill which increased next year's Part B premium. The Ways and Means Committee could do this by adopting Representative Claude Pepper's H.R. 3291 which has 97 cosponsors.

When Congress passed the automatic Social Security COLA provision in the early seventies, it also limited Part B premium increases to no more than the rate of the COLA increase. In doing so, Congress decided that beneficiaries should not pay for the failure of Congress and the Administration to control medical inflation. However, beneficiaries have been paying for the failure to control medical inflation since 1984 when the Part B premium was increased to cover 25 percent of program costs. While only "temporary," Congress has extended the provision three times, creating the impression of a de facto permanent increase.

The latest one-year temporary extension through 1990 was particularly galling to beneficiaries since it came on the heels of the 38.5 percent premium increase last January even though the COLA increase was only 4.2 percent. According to Health and Human Services Secretary Bowen's own comments in a recent Budget Committee hearing, keeping the 25 percent share could mean a $36.70 monthly premium by 1992, and as much as a $50 premium when the catastrophic coverage is included.

Despite Social Security and other public programs, an estimated 40 percent of seniors live below 200 percent of the poverty line with incomes less than $11,000 for single individuals. For these seniors, every dollar that must be spent out-of-pocket for medical care is important.

One National Committee member, a woman from Paradis, Louisiana, finds it a struggle to make ends meet. "I don't have enough money for my bare necessities. Right now I would need to go

to the grocery store for a few things that I have ran out of, but I have to wait until my next check (in ten days)... I have a hard time with all the medicine bills that I need every month. I need medicine for my heart, blood pressure, degenerative joint disease, arthritis, spasms, backache so bad that I can hardly breathe... I also have to pay a big premium for Blue Cross supplemental... When we get a COLA raise sometimes it does not cover the raise of Medicare Part B and Blue Cross raise."

Another 68-year old woman from Bluefield, West Virginia, trying to live on $372 per month finds that after paying rent and food there is very little left for medical bills. "After I pay my bills and buy my medicine, I have $39.00 a month to live on. Yet they claim I get too much to get any help."

Some people forego medical visits and needed medicine because they cannot afford to pay the bills. A 71-year old woman from Detroit, Michigan, wrote: "I can't afford a doctor because my blood pressure pills and water pills are so high, I use garlic water and vinegar water and lie down when I get dizzy." From Campbell, Ohio, another members writes: "I have to go to the hospital and I can't go - I don't have the money to pay the doctor or the hospital..."

Many poor seniors are not protected by the Medicaid program, either because they have incomes slightly higher than the threshhold for Medicaid eligibility, or because the state in which they reside does not pay for Medicare premiums and deductibles as part of a buy-in provision. These are the seniors who will be hit the hardest with new and uncontrolled premium increases next year and in future years, unless Congress acts now to limit to premium increases to the rate of the Social Security COLA.

It is difficult enough to get old and gradually lose your ability to carry on your normal daily functions without living in fear of being able to afford medical care. Please work toward protecting seniors from further out-of-pocket medical costs.

STATEMENT OF ROBERT J. SCOTT

ON BEHALF OF

ORGANIZATION FOR THE PRESERVATION OF THE PUBLIC EMPLOYEES' RETIREMENT INDUSTRY AND OPPOSITION TO SOCIAL SECURITY EXPANSION TO SUCH INDUSTRY

(OPPOSE)

Members of the House Committee on Ways and Means, I am Robert J. Scott, secretary-treasurer of OPPOSE. OPPOSE is a Colorado corporation formed by teachers, firefighters, police, and other state and local government employees who have elected not to join the Social Security system. The purpose of our organization is to assure the continued financial integrity of our members' retirement and health insurance plans by resisting congressional efforts to mandate Social Security or Medicare coverage of public employees. Our members are found in Alaska, California, Colorado, Illinois, Kentucky, Louisiana, Massachusetts, Nevada, and Ohio. With respect to the issue of mandatory Medicare coverage, the interests of OPPOSE are identical to those of the four to five million public employees throughout the nation who remain outside the Social Security system.

Through this testimony, we wish to express our strong opposition to the proposal in the Administration's budget for fiscal year 1989 to impose Medicare Part A coverage upon all state and local government employees effective December 1, 1988.

By way of background, I would remind you that employees of state and local government were not permitted to join the Social Security system when it was established in 1935. While they have been permitted to join since the 1950s, those who have chosen to remain outside the system have their own retirement plans and, in many instances, health insurance plans.

Under current law, all employees of state and local government hired on or after April 1, 1986, are required to participate in the Medicare system. This is the result of a compromise adopted in the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), which phased in Medicare coverage gradually, by covering newly hired workers and leaving older workers grandfathered outside the system. Through adoption of this phase-in provision, which will result in Medicare coverage of all public employees through normal job turnover, Congress ensured that all public employees will ultimately pay the full Medicare tax to the federal government. The individuals excluded from coverage under COBRA were those who were already working and for whom the Medicare tax would both constitute a pay cut and jeopardize their existing health benefits. While we at OPPOSE did not favor mandatory Medicare coverage, we believed that the phase-in provision adopted in COBRA was a reasonable, permanent solution that avoided imposing overwhelming burdens on state and local governments and their employees.

Proposals to reopen the issue and expand coverage to include all state and local government workers were wisely rejected by Congress in 1986 and 1987.

The new twist this year is that the Administration has specifically linked the proposal to expand mandatory

coverage with an array of completely unrelated spending proposals. These include measures to allow companies to allocate a greater portion of research and experimentation expenditures to domestic income, to establish a permanent research and experimentation tax credit, and to exempt permanently from the two percent floor for miscellaneous deductions certain mutual fund shareholder expenses.

Because they bear no connection to the question of mandatory Medicare coverage, OPPOSE takes no position with respect to the Administration's various spending proposals in and of themselves. However, mandatory coverage is an entirely inappropriate means of financing such measures. Moreover, we at OPPOSE believe that the phase-in compromise reached in COBRA should be respected and that our employees and retirees should not be visited by the same threat year in and year out. Therefore, and for the reasons set forth below, OPPOSE asks you once again to reject the proposal to extend mandatory Medicare coverage to all state and local government employees.

1. The linkage of mandatory Medicare coverage of state and local government employees with the various spending proposals incorrectly suggests that the revenues mandatory coverage would raise would be available to be spent for purposes other than payment of Medicare benefits. This suggestion reflects a complete misunderstanding of the mechanism for financing the Medicare system. Like the Old Age and Survivors and Disability programs, the Medicare Part A program is funded entirely through payroll taxes, which are credited to a separate trust fund. Indeed, the Social Security Act specifically provides for the transfer to the Health Insurance ("HI") trust fund of an amount equal to the amount raised through imposition of the HI tax. Thus any revenues that would be raised by extending the Medicare tax to a new class of individuals would automatically be credited to the Medicare trust fund. They would not become part of the general revenues and are not available, even in the short run, to fund new measures such as the establishment of a permanent research and expenditures tax credit. Any contrary assertion is simply an attempt at accounting chicanery.

By suggesting that mandatory Medicare coverage presents an available revenue source, the Administration's proposal also ignores the fact that the newly taxed individuals would also become newly entitled to benefits. Indeed, their benefits might well be relatively more expensive than the benefits of the average covered individual. Like the federal employees who were brought into the system in 1983, newly covered state and local government employees would become entitled to the full package of Medicare benefits despite having spent a portion of their careers outside the system and having paid a relatively small amount of the HI tax as a result. Particularly given the projected decline in the HI trust fund's balance in the next decade, the revenues raised by an expansion of mandatory Medicare coverage would be needed to offset the cost of additional benefits.

Recent reports have indicated that the magnitude of the deficit problem the country faces in the next decade is masked, in part, because the Social Security trust funds, which are counted for purposes of deficit calculation, will begin to build large surpluses that must be expended on benefits in the next century. Congress should not add to this problem by enacting spending proposals and claiming to fund them by revenues which are credited to the HI trust fund and necessary to pay future benefits.

2. The linkage of mandatory coverage with the Administration's various other spending proposals is also inappropriate because the revenues raised by the mandatory coverage proposal would shortly decline to zero, while the various spending proposals would require permanent sources of financing. Through the operation of COBRA's provision imposing coverage on newly hired employees, the turnover of the workforce has resulted in a larger percentage of the public employee workforce being covered each year. Correspondingly, fewer employees remain outside the system, representing a declining revenue base as time progresses. Thus, the revenues that the mandatory coverage proposal would raise will dry up entirely in a relatively short time and would not be available for any purpose in the long run. On the other hand, the items that the Administration proposes to finance through mandatory coverage are permanent, and require a permanent source of financing. Enacting the spending proposals on the pretext that mandatory coverage would pay for the Administration's spending proposals would actually exacerbate the deficit problem.

3. Because the Administration's revenue estimates do not reflect a decline in the amount that this proposal would raise over time, the estimates are themselves open to challenge even concerning the amount that would be raised in the first year. The Administration estimates that the mandatory coverage proposal would raise $1.6 billion in fiscal year 1989 and $2.1 billion in each of the next two years. We estimate the overall turnover rate for state and local employee groups to be approximately 9 percent per year. (See Table A, attached, which sets forth data concerning the rate of coverage since implementation of COBRA in 1986.) Thus, using this estimate, approximately one-quarter of the state and local government employees who were outside the Medicare system before COBRA will be covered by the system by the effective date of the Administration's proposal, and that number is on the increase. The Administration's revenue estimates, which do not reflect a decline in revenues in the out years -- or, indeed, any decline in the revenue estimates since last year when the same mandatory coverage proposal was made -- are simply inaccurate with respect to the later years and suggest that the effect of COBRA was not taken into account in the estimate for fiscal year 1989.

4. The proposal would have an extremely negative fiscal impact upon the affected state and local governments. While the impact of the proposal would fall most heavily upon governments in approximately 10 states,*/ forty-nine states include at least some subdivisions with non-covered employees that would be significantly harmed by these additional operating costs. Estimates of the annual cost to state and local government are set forth state-by-state in Table B, attached. For example, the proposal would cost governments in Ohio $164 million annually; the cost in Illinois would be $82 million; and the cost in Massachusetts would be $91 million.

Imposition of these additional costs would come at a difficult time. State and local governments have repeatedly been forced to shoulder additional burdens in recent years, resulting from considerable cuts in the federal appropriations for many of their programs and the loss of revenue-sharing, while the Tax Reform Act of 1986 limited their ability to raise revenues, through loss of

---

*/ Alaska, California, Colorado, Illinois, Louisiana, Maine, Massachusetts, Nevada, Ohio, and Texas.

the sales tax deduction and new restrictions upon municipal bonds. A recent study by the National League of Cities concluded that almost one-third of U.S. cities andtowns anticipate a decline in their general revenue funds this year. Many local governments must raise taxes to maintain existing public service spending levels formerly funded through

revenue-sharing. The result is that state and local governments are in no shape to absorb additional fiscal burdens.

To cite a few examples, a number of California counties have recently been required to close public libraries and parks as a result of budget shortfalls. Last year, the President of the Board of Commissioners for Trumbull County, Ohio, testified that, as a result of the loss of revenue-sharing, 39,000 citizens in his county were without police protection. Many governments at all levels around the country would find that imposition of the new 1.45% Medicare tax would force them to make very hard choices among essential services and staff.

5. Despite the promise of the President not to raise taxes and the efforts of Congress to provide tax relief to lower- and middle- income individuals, this proposal targets 4 to 5 million lower- and middle-income Americans and their spouses for a tax increase that would more than offset the tax cut they received from the Tax Reform Act of 1986. The President has repeatedly promised not to raise taxes and frequently asserts that taxes may not be raised under the budget summit agreement reached late last year. Yet the mandatory coverage proposal is a proposal to raise taxes for 4 - 5 million Americans.

According to the Joint Committee on Taxation, the Tax Reform Act provided taxpayers with incomes in the range of $20,000 - 30,000 with a cut equivalent on the average to $220. The new Medicare tax that would be imposed upon state and local government employees equals 1.45 percent of payroll. Thus, to consider one example, in the case of the average government employee in Colorado (whose annual salary is $25,066), the new Medicare tax of $363 would result in a net tax increase of $143. For the average Illinois teacher, who makes $25,454 annually, the new tax of $369 would more than offset the meager $281 that now remains to such an individual annually after he or she pays for basic expenses. The increased tax burden for both would be even higher if the 1.45 percent tax that would be newly imposed upon their employers is passed along to employees.

6. The affected individuals are politically significant and can be expected to respond at the polls to a measure that singles them out for a major tax increase. Numbering between 4 and 5 million, these individuals are concentrated in such key states as California, Texas, Massachusetts, Ohio, and Illinois. The number of public employees outside the Social Security system equals approximately 4.7 percent of the voters in the 1980 presidential election and about 3.96 percent of those who voted in 1984. In the close Senate races of 1986, the number of public employees outside of the system exceeded the margin of victory in nine states -- Alabama, Alaska, California, Colorado, Georgia, Louisiana, Nevada, North Dakota, and Washington. If the number of public employees is doubled to take into account their spouses, the number also exceeded the margin of victory in Missouri, North Carolina, Ohio, and Wisconsin. These voters can realistically be expected to influence the outcome of the presidential and local and statewide elections this year.

7. Mandatory coverage can not be justified on the grounds that it would benefit the affected employees. The Administration attempts to justify its proposal with the paternalistic concern that "[a] minority of State and local government employees. . . may not be assured of medicare coverage." The response to this concern is simple: if those public employees wanted Medicare coverage, they would have it. Since the passage of COBRA, local jurisdictions have had the option of joining the Medicare system without also participating in the Social Security system. If Medicare coverage were desirable, employees would certainly bring pressure to bear upon their employers to adopt it. In fact, the opposite is true; public employee groups are vehemently opposed to mandatory Medicare coverage and do not need the federal government to provide it "for their own good."

* * *

For these reasons, we urge you once again and finally to reject the proposal to extend mandatory Medicare coverage to include all state and local government workers. Thank you once again for allowing me this opportunity to present the views of OPPOSE.

TABLE A

OPPOSE

APRIL 1988

STATE AND LOCAL GOVERNMENT EMPLOYEE TURNOVER AND SALARY INCREASE RATES
(as of January 1, 1988, unless otherwise indicated)

Organization	# of Employees or Members Out-Side FICA System	Average Annual Salary	Average Annual Salary Increase (1983-1988)	% Covered by Medicare as of 1/1/88	% Covered by Medicare as of 1/1/87
			ALASKA		
Alaska Public Employees Ass'n	13,206*/	$35,000	2%	21%	N/A
			CALIFORNIA		
City of Los Angeles	42,079	$36,238	6%	13%	6%
City of Pasadena	2,366	$22,950	4.5%	32%	15%
City of San Diego	6,733	$29,643	5%	26%	14%
Engineers & Architects Ass'n of Los Angeles	5,000	$36,000	5%	20%	N/A
Los Angeles County	68,330	$29,994	4%	21%	13%
San Diego Unified School District	5,758	$35,540	7%	10%	7%

*/ Data reported concerns state employees only.

Organization	# of Employees Outside FICA System	Average Annual Salary	Average Annual Salary Increase (1983-1988)	% Covered by Medicare as of 1/1/88	% Covered by Medicare as of 1/1/87
State Teachers' Retirement System	271,764	$32,689	6%	10%	4%
			COLORADO		
Public Employees' Retirement Ass'n of Colorado	103,232	$25,066	6%	22%	10%
			FLORIDA		
City of Tallahassee	2,154	$21,208	6%	19%	N/A
			ILLINOIS		
Illinois State Teachers' Retirement System	100,175*/	$25,454	N/A	18%	N/A
			KENTUCKY		
Teachers' Retirement System of the State of Kentucky	45,770	$24,186	4%	18%	12%
			MAINE		
State of Maine	14,272	$20,000	4%	17%	N/A

*/ Information provided is as of 9/1/87.

Organization	# of Employees Outside FICA System	Average Annual Salary	Average Annual Salary Increase (1983-1988)	% Covered by Medicare as of 1/1/88	% Covered by Medicare as of 1/1/87
			MASSACHUSETTS		
Commonwealth of Massachusetts	89,709	$27,103	6%	24%	N/A
			MICHIGAN		
City of Detroit	5,185	$25,944	4%	19%	13%
			MISSOURI		
City of St. Louis	500	N/A	N/A	10%	N/A
			MONTANA		
City of Missoula	112	$21,491	2%	14%	7%
			NEVADA		
Regional Transportation Commission	30	$27,504	N/A	30%	20%
State of Nevada	10,500	$24,166	3%	24%	10%
			OHIO		
State of Ohio	58,221	$23,312	6%	20%	12%
State Teachers Retirement System of Ohio	165,719	$27,050	7%	16%	7%

Organization	# of Employees Outside FICA System	Average Annual Salary	Average Annual Salary Increase (1983-1988)	% Covered by Medicare as of 1/1/88	% Covered by Medicare as of 1/1/87
			TEXAS		
City of Fort Worth	5,146	$22,006	5%	21%	13%
*	*	*	*	*	
ALL ORGANIZATIONS	1,015,961	$28,470	6%	16% (9% per year)	7% (9% per year)

5360T

Table B

April 1, 1988

ANNUAL COST TO STATE AND LOCAL GOVERNMENTS
OF MEDICARE COVERAGE OF ALL EMPLOYEES
(in millions of dollars) 1/

State	Number of Public Employees Who Are Not Covered by the Social Security System 2/	Number of Public Employees who are not covered by the Medicare system 3/	Percentage of Public Employees Not Covered by Medicare 3/	Cost of Medicare Coverag of All State and Local Employees 4/
Alabama	37,000	22,140	9.0	7.4
Alaska	40,000	31,800	58.4	10.9
Arizona	31,000	17,220	9.0	5.7
Arkansas	59,000	31,980	10.7	10.7
California	991,000	813,620	51.7	271.0
Colorado	190,000	123,000	62.3	41.0
Connecticut	63,000	51,660	30.3	17.2
Delaware	14,000	11,480	27.9	3.9
Florida	127,000	104,140	17.3	34.7
Georgia	64,000	52,480	14.8	17.5
Hawaii	34,000	19,680	37.1	6.6
Idaho	0	0	0	0
Illinois	299,000	245,180	39.4	81.8
Indiana	54,000	44,280	13.9	14.8
Iowa	5,000	4,100	1.6	1.4
Zansas	2,000	1,640	.8	.6
Kentucky	56,000	45,920	22.1	15.3
Louisiana	271,000	222,220	69.7	74.1
Maine	52,000	42,640	58.2	14.2
Maryland	29,000	23,780	8.2	8.0
Massachusetts	334,000	273,680	82.0	91.3
Michigan	19,000	15,580	3.3	5.2
Minnesota	96,000	78,720	37.1	28.2
Mississippi	2,000	1,640	.8	.6
Missouri	62,000	50,840	18.0	17.0
Montana	5,000	4,100	7.4	1.4
Nebraska	2,000	1,640	1.6	.6
Nevada	49,000	40,180	77.1	13.4
New Hampshire	6,000	4,920	8.2	1.6
New Jersey	30,000	24,600	4.9	8.2
New Mexico	33,000	27,060	22.1	9.0
New York	153,000	125,460	9.8	41.8
North Carolina	43,000	35,260	9.0	11.7
North Dakota	6,000	4,920	8.2	1.6
Ohio	593,000	487,900	82.0	164.1
Oklahoma	33,000	27,060	13.3	9.0
Oregon	14,000	11,480	5.7	3.9
Pennsylvania	36,000	29,520	4.9	9.8
Rhode Island	23,000	20,500	25.5	6.8
South Carolina	6,000	4,920	3.5	1.6
South Dakota	3,000	1,640	4.1	.6
Tennessee	29,000	23,780	9.8	8.0
Texas	488,000	398,530	41.0	132.8
Utah	1,000	820	.8	.3
Vermont	1,000	820	1.6	.3
Virginia	73,000	59,860	14.8	19.7
Washington	36,000	29,520	10.7	9.8
West Virginia	7,000	5,740	4.9	1.9
Wisconsin	48,000	39,360	13.1	13.1
Wyoming	5,000	4,100	8.2	1.4
TOTAL	4,546,000	3,727,730		$1,249.3

1/ These figures reflect only the 1.45% that must be paid by the governments as employers, and do not include the cost increases to their employees, who must also begin to pay the 1.45% Medicare tax. (See reverse side for increased tax burden on individual employees.)

2/ Social Security Administration, 1986 Current Population Survey and Continuous Work History Sample as cpncluded in Congressional Research Service paper "Medicare Coverage of Employees of State and Local Government," prepared at the request of the Subcommittee on Health of the House Committee on Ways and Means by David Koitz, Specialist in Social Legislation, Education and Public Welfare Division (March 11, 1987).

3 The Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. 99-272, requires public employees hired after March 31, 1986 to participate in the Medicare system. Because employee turnover occurs at a rate of approximately 5% per year, in the two years since COBRA took effect, approximately 10% of previously non-covered public employees are now covered by Medicare. The number of public employees covered by Social Security has therefore been reduced by 18% to reflect the number of employees who are not now covered by Medicare.

3/ Given that the employer's part of the 1987 Medicare tax is 1.45%, and assuming that the salary of the average state or local government employee is $23,000, each governmental employer's cost is equal to the number of employees, multiplied by 23,000, multiplied by 1.45%.

ANNUAL COST TO STATE AND LOCAL GOVERNMENT EMPLOYEES
OF MEDICARE COVERAGE OF ALL EMPLOYEES

State	Annual salary of average public employee 1/	Annual tax increase resulting from proposal 2/	Average tax decrease resulting from the Tax Reform Act 3/
Alabama	$19,272	$279	$200
Alaska	39,084	567	273
Arizona	24,996	363	220
Arkansas	17,796	258	200
California	30,084	436	273
Colorado	23,676	343	220
Connecticut	24,360	353	220
Delaware	22,884	332	220
Dist. of Columbia	33,288	483	273
Florida	20,556	298	220
Georgia	19,056	276	200
Hawaii	22,596	328	220
Idaho	18,852	273	200
Illinois	24,780	359	220
Indiana	22,560	327	220
Iowa	21,024	305	220
Kansas	20,124	292	220
Kentucky	19,248	279	200
Louisiana	19,080	277	200
Maine	18,444	267	200
Maryland	27,144	394	220
Massachusetts	23,976	348	220
Michigan	26,808	389	220
Minnesota	25,296	367	220
Mississippi	16,116	234	200
Missouri	20,244	294	220
Montana	22,284	323	220
Nebraska	18,588	270	200
Nevada	23,676	343	220
New Hampshire	19,308	280	200
New Jersey	24,192	351	220
New Mexico	19,608	284	200
New York	26,220	380	220
North Carolina	19,956	289	200
North Dakota	21,984	319	220
Ohio	21,492	312	220
Oklahoma	18,816	273	200
Oregon	22,632	328	220
Pennsylvania	23,068	330	220
Rhode Island	24,204	351	220
South Carolina	18,120	263	200
South Dakota	17,232	250	200
Tennessee	18,588	270	200
Texas	20,676	300	220
Utah	21,528	312	220
Vermont	19,248	279	200
Virginia	20,652	299	220
Washington	24,204	351	220
West Virginia	17,940	260	200
Wisconsin	23,148	336	220
Wyoming	22,404	325	220

1/ U.S. Bureau of the Census, Public Employment in 1985 - Government Employment (Series GE85-No.1) at 8.

2/ The amount of the new Medicare tax is derived by multiplying the average employee's salary by 1.45%.

3/ Joint Committee on Taxation Staff, Data on Distribution by Income Class of Effects of H.R. 3838, Tax Reform Act of 1986 (JCX - 28-86) (October 1, 1986), Table 4.

STATEMENT OF THE
RENAL PHYSICIANS ASSOCIATION
TO THE
HOUSE COMMITTEE ON WAYS AND MEANS
ON
THE PRESIDENT'S BUDGET FOR
FISCAL YEAR 1989
APRIL 15, 1988

The Renal Physicians Association (RPA) appreciates the opportunity to share with the Committee the views of nephrologists throughout the country on the President's Fiscal Year (FY) 1989 budget proposal. The Renal Physician Association (RPA), an organization representing over 1,300 nephrologists nationwide, is a professional organization whose goals are: (1) to ensure optimal care under the highest standards of medical practice for patients with renal disease and related disorders; (2) to act as a national representative for physicians engaged in the study and management of patients with renal disease and related disorders; and (3) to serve as a major resource for the development of national health policy concerning renal disease.

While RPA acknowledges the grave status of the federal deficit and the need for budget reform, RPA must firmly oppose the proposed Medicare cuts of $1.3 billion contained in the Administration's FY 1989 budget. These reductions would be in addition to the series of cuts implemented in last year's budget reconciliation.

Two provisions in the President's budget are aimed at reforming the Endstage Renal Disease (ESRD) system. RPA believes it should address these provisions separately from a discussion of acceptance of the President's budget, but rather on their merits. The first proposal would require beneficiaries using Method II (a method of payment for home dialysis equipment and supplies) to enter into a written agreement with one supplier to furnish all equipment and supplies. Further, reimbursement would be limited to the national average composite rate.

The RPA endorses this proposal, but has the following additional concerns that were not addressed in the proposal:

Where the supplier is providing (in addition to supplies) the dialysis service, RPA believes provisions must be in place to:

- o comply with state regulations for the delivery of home dialysis services in all states that services are provided; ongoing surveillance by state surveyors should be required;
- o provide adequate quality assurance programs, including sufficient back-up systems in place; and
- o address how laboratory services are provided and paid for.

The second proposal would make Medicare's secondary payor requirements under ESRD more uniform with the rest of the Medicare program. Our discussions with HCFA staff lead as to believe that this would just extend, beyond one year, the availability of other insurance payors as primary payors, leaving Medicare as the secondary payor. The RPA supports this proposal, as outlined above, as long as the practical application of such a policy does not create problems for beneficiary access to covered services, due to problems with reimbursement. There would need to be oversight over the application of this provision. Should the proposal be more extensive than that, such as outlined in an earlier draft budget proposal, the RPA would have serious concerns over the impact such a proposal might have. Given that the budget document is unclear in its intent, RPA would like to ensure that its position is clearly understood.

Reductions in the Medicare Program

Over the past seven years, the Medicare program has endured a disproportionate share of federal budget cuts--the impact of which has not yet been fully realized. A comparison of actual Medicare spending and the Office of Management and Budget projected current services spending reveals that Medicare funding has been reduced by $7.9 billion since 1980. Under the Omnibus Budget Reconciliation Act of 1987 (OBRA), P.L. 100-203, Medicare again bore the brunt of federal budget cuts to human resource programs in order to meet budget targets agreed to in the November 1987 bipartisan budget

agreement. OBRA reduces Medicare outlays in FY 1988 by $2 billion and by an additional $3.5 billion in FY 1989. Further reductions in Medicare, compounding a seven-year pattern of major reductions, we believe, would adversely affect the quality of care for Medicare beneficiaries.

It is RPA's position that the Medicare program should not be subjected to additional cuts in FY 1989. RPA agrees with Chairman Rostenkowski that Congress should adhere to the provisions of OBRA 1987 as it upholds the spending targets established by the budget summit between Congress and the Administration. Implementation of further reductions in Medicare at this time would be a violation of the two-year bipartisan budget agreement.

Reductions in Medicare Part B

The President's budget specifically proposes additional reductions in Medicare Part B outlays--estimated at $300 to $330 million--after years of targeted cuts. The Deficit Reduction Act of 1984 mandated a one-year freeze on Medicare reimbursement for physicians' services, which Congress extended to a full 30 months for non-participating physicians; under the Sixth Omnibus Budget Reconciliation Act of 1986 (SOBRA), certain limits on actual and prevailing physician charges, including maximum allowable actual charges (MAAC), were imposed. Although SOBRA increased prevailing charges by the full Medicare Economic Index (3.2%) on January 1, 1987, physicians' charges were not competitive with the rate of increase of overhead costs because the update was added to 1984 charges. Physician payment under the ESRD program within Medicare has been subjected to even more drastic cuts and freezes in payment. No Medicare Economic Index (MEI) is applied to the monthly capitation payment (MCP). Physician payment updates under OBRA 1987 are dependent on what type of service is being provided and whether the physician is participating or non-participating under Medicare. While RPA commends Congress for acknowledging the need for greater reimbursement for primary care services by updating payment under OBRA for these services by 3.6 and 3.1 percent for participating and non-participating physicians, respectively, RPA believes that further limits or cuts in physician payment under Medicare Part B should be avoided. In addition, if anything, recognition of the fact that the MCP is based on "primary care" services--the brief and intermediate office visit--and that while these services were increased relative to other services, the MCP remains stagnant.

The effects of past cuts have not yet been fully experienced, and additional reductions in Medicare could adversely affect the quality of care furnished to beneficiaries and create a two-tiered system of medical care. Specifically, the Administration's proposed FY 1989 budget provides for reductions in reimbursement for radiology and anesthesiology services by 10 percent and development and implementation of separate fee schedules for these services. Separate fee schedules as proposed by the President (and Congress in OBRA 1987) could result in fragmentation of the medical profession and undermine the effectiveness of the resource cost-based relative value scale (RVS) under development at Harvard University. The Physician Payment Review Commission (PPRC) supports the development of a resource cost-based RVS and will be evaluating the Harvard RVS for suitability for a Medicare fee schedule. Congress itself has recognized the importance of the Harvard study by including in OBRA 1987 provisions that delay until July 1989 the requirement that the Secretary of the Department of Health and Human Services develop a relative value scale as a basis for payment under Medicare, thus allowing for completion of the Harvard study and availability of its results for incorporation in a national fee schedule. Since the budget compromise agreement is valid for another year--by which time we should be close to implementing a fee schedule--RPA urges the Committee to oppose any major changes in the existing payment system under Medicare until the Harvard RVS study is available for implementation.

Reductions in Graduate Medical Education

Included in the Administration's proposed Medicare cuts are significant reductions in funding for graduate medical education (GME). Specifically, direct GME payments--direct payments to teaching hospitals for the costs of services furnished by interns and residents, including salaries, fringe benefits and program costs--would be reduced to provide savings of $60 million. The adjustment factor for calculating indirect medical education payments is proposed to be reduced from 8.1 to 4.05 percent; this factor is already scheduled to decrease to 7.6 percent in FY 1989 under OBRA 1987. The indirect GME payment factor under the hospital prospective payment system provides an adjustment for the higher patient care costs incurred by hospitals with medical education programs and reflects the increased demands that residents place on other hospital staff

and the tendency of residents to provide more services and conduct more tests than experienced physicians.

RPA acknowledges that reductions in the reimbursement for the indirect costs of GME may be appropriate in efforts to reduce federal spending, but only after a study has been undertaken to determine precisely what costs are due to teaching (more tests, more procedures, etc.) versus other factors (the particular types of patients a teaching hospital may attract) and only after alternative sources of funding have been identified. The entire question of how this country should finance graduate medical education has not been answered, and the commission established to address this question is not adequately funded to pursue it vigorously. Abrupt reductions in Medicare support for post medical school education could have major adverse effects on the hospitals now receiving Medicare funds, on health professionals currently in training programs, on individuals considering future careers in the health care professions and ultimately, on the general public. Before Medicare funding for GME is further reduced or eliminated, the policy question of who will pay for graduate medical education must be solved. RPA requests the Committee to resist further FY 1989 cuts in graduate medical education until there is a better understanding of exactly what Medicare is paying for, particularly in the adjustment for indirect GME costs, and until alternative sources of funding are guaranteed.

Conclusion

RPA commends the House of Representatives for not supporting the President's proposed FY 1989 Medicare cuts in the House budget, passed on March 23. Additional cuts in Medicare at this time would violate the two-year spending plan agreed to by Congress and the Administration in the bipartisan budget summit. RPA believes that the reductions implemented by OBRA 1987 fully execute the budget agreement. Therefore, in keeping with the House-passed FY 1989 budget, we urge the Committee to reject the Administration's credence that Medicare savings provided under OBRA do not fulfill the terms of the budget summit. RPA recommends that the Committee uphold the generally accepted understanding that P.L 100-203 satisfies the budget summit agreement.

M-HW-0446a/jp

TESTIMONY OF RUTH THOMPSON JONES PREPARED FOR THE U.S. HOUSE OF REPRESENTATIVES WAYS AND MEANS COMMITTEE, APRIL 8, 1988, ON INCREASES IN MEDICARE PART B PAYMENTS PROPOSED IN THE ADMINISTRATION BUDGET.

Ms. Jones is the Editor of The Senior Review, a non-profit newspaper serving 10,000 elderly residents of Kanawha County, West Virginia. Her testimony was prepared with the help of Congressman Bob Wise and the Social Security Claims Office in Charleston, West Virginia.

To begin with, I would like to quote from Victoria Jaycox, the Executive Director of the Older Women's League. "To be old" Ms. Jaycox said to me once in an interview, "is to be poor". According to data provided by the staff of Congressman Bob Wise there are approximately 15 million elderly with incomes of less than ten thousand dollars ($10,000.00) a year who will pay 25% of the federal bill for the Medicare Part B program.

In Kanawha County there are 43,117 social security recipients according to the Social Security Administration Office of Policy Research, Statistics and International Policy. This figure comes from SSA Publication 13-11954 and is found on page 219. This includes retirement, insurance and disability programs.

Despite the enormous cumulative increase of 255 percent in Part B outlays between 1976 and 1983, the administration has proposed further increases. Furthermore, the budget agreement extends for one additional year, 1989, premiums for Medicare Part B (which covers physicians services and other non-hospital costs) be set at a level sufficient to recover 25% of program costs. This temporary provision overrides a permanent rule that would limit the percentage of increase in the Part B premium to the most recent increase in social security benefits.

Increase in Part B premiums and aligned to increases in social security benefits would produce great hardships for the low-income elderly. This is especially true with the trend toward shorter hospital stays and the increasing use of in-home health services.

I would like to strongly urge that Medicare Part B premiums not be increased in this way.

Respectfully submitted,

Ruth Thompson Jones

Ruth Thompson Jones